# Adopted 2004/2005 Budget
# and
# Ten-Year Resource Allocation Plan

# City Manager's
# Letter of Transmittal

# Table of Contents

*Honorable Mayor and Members of the City Council:*

## CITY MANAGER'S MESSAGE

## INTRODUCTION

I am pleased to present for your review and consideration the recommended FY 2004/2005 Budget and accompanying Ten-Year Resource Allocation Plan (RAP). In addition, financial projections are provided for a second ten years, ensuring a full 20-year perspective for financial planning. In keeping with Council policy, each fund is balanced to the twentieth year when coupled with certain financial strategies that have been developed for Council's consideration. This has been a difficult task again this year as the City continues to address our ongoing structural imbalance between revenues and expenditures.

FY 2004/2005 is the first year of the two-year operating budget cycle. The two-year cycle for operating programs was established to recognize the fact that in normal times service levels change only modestly from year to year, and that resource requirements can be effectively planned over a two-year time frame. Since most operating programs are not normally reviewed extensively for the second year, a significant amount of staff time is saved. This staff time can be directed toward service delivery, continuous improvement efforts, and Council study items. However, certain key factors in the operating budget, such as major revenue sources, personnel costs and enterprise activities, are reviewed each year in order to ensure the accuracy of our long-term projections. These factors and the process that we utilized in preparing the recommended FY 2004/2005 Budget are discussed in more detail later in this Transmittal Letter.

Last year, as we planned for FY 2003/2004 and beyond, Sunnyvale was faced with a financial situation that was more difficult than any in recent memory. Three major factors contributed to the problem:

- The worst economic downturn in the Silicon Valley since the Great Depression, as measured in job loss, had a dramatic effect on the City's revenues
- Personnel costs were increasing at rates substantially higher than inflation and higher than we previously included in budget projections
- The State was undergoing a severe budget crisis as a result of the economic downturn over the last few years

These conditions created a structural gap between ongoing revenues and ongoing expenses in the General Fund that totaled about $15 million on an annual basis. In order to address this gap, we undertook a comprehensive review of both the project and operating budgets and reexamined the fees, charges, and local taxes that produce the revenues needed to provide City services. The following chart summarizes how the structural gap was addressed in the Adopted FY 2003/2004 Budget and Long Term Financial Plan:

| Estimated Savings to Reduce Ongoing Revenue to Expense Gap | Amount |
|---|---|
| Capital Projects Plan | $1,800,000 |
| Rental Rates/In-Lieu Fees (Equipment) | $500,000 |
| Department Service Level/Expense Reductions | $8,455,059 |
| Rental Rates (Operating Expenses) | $1,427,019 |
| Set-Asides | $1,250,000 |
| New Revenues | $1,426,000 |
| **Grand Total** | **$14,858,078** |

These proposed service level reductions and revenue enhancements were programmed to take effect over a two-year period, from FY 2003/2004 to FY 2004/2005. Many of the service level reductions have been implemented this year, with the remainder on schedule for next year. A discussion of the status of the proposed revenue enhancements is included in *Volume I, User Fees* in this budget document. Combined, the service level reductions and revenue enhancements are on track with the almost $15 million that was projected.

## COUNCIL BUDGET REVIEW PROCESS FOR FY 2004/2005

The City Council will be forced again this year to make difficult and painful choices as it considers the recommended FY 2004/2005 Budget and Ten-Year Resource Allocation Plan. Our budget continues to have a structural imbalance between revenues and expenditures as our key revenue sources such as Sales and Use Tax and Transient Occupancy Tax ("TOT") remain below historic averages while the City's ongoing costs are continuing to rise. This condition is expected to be in place for the first five years of the Long Term Financial Plan.

The City Council directed staff to develop and use a different approach for preparing the recommended FY 2004/2005 Budget. The new process would allow Council to provide preliminary policy direction before the recommended Budget was prepared. In addition, Council wanted to offer more opportunities for the public to comment and participate during budget preparation.

This revised approach amended the current budget process in four important ways:

- Council prioritized all City services and considered revisions to service levels during a series of special budget meetings held in March and April 2004.
- Council considered an unbalanced budget in April and provided preliminary policy direction on issues and options staff should examine and potentially use to prepare a balanced, recommended FY 2004/2005 Budget.
- Special City Council meetings were added to the budget calendar to allow more and earlier Council involvement as the recommended FY 2004/2005 Budget was being prepared.
- Public hearings were provided at these budget meetings to encourage more public involvement and participation in the budget process. In addition, multiple

methods have been used to inform the public about these special meetings and to encourage their participation and involvement in the new budget process.

Through this revised process, Council prioritized nearly 600 City services. Council provided preliminary policy direction for 68 services to either reduce service levels by five or ten percent, to increase services, or to eliminate services. This direction would result in a net reduction to the General Fund of $1.9 million.

Council also directed staff to identify the effects of these service deletions, reductions, and increases to services. *Volume I, Budget Supplements*, in this budget document, provides detailed information on services identified by Council for possible reduction, increase, or elimination. Budget Supplement Number 3 discusses the effects identified by staff of Council's policy direction and the fiscal impact. Finally, it contains the City Manager's recommendations for each service identified. However, the City Manager is recommending that the Council's decision on these budget reductions be made in December 2004. This will allow a more thorough study of each option and time to develop plans for implementation. Also, there are a number of unknowns in our current fiscal environment at this time (the State budget, the economic recovery, etc.) that will be clearer in the near future. This timing has been reflected in the recommended FY 2004/2005 Budget and Ten Year Resource Allocation Plan.

## OVERVIEW OF PROPOSED CAPITAL AND SPECIAL PROJECTS BUDGET

In keeping with the separation of the operating and project budget cycles, FY 2004/2005 is the second year of a two-year capital and special projects budget. For this submittal, project scope or cost was updated as necessary, and a small number of new projects were proposed. As a result of the project budget process this year, I am recommending $22,615,578 in projects in FY 2004/2005 and a total of $81,631,821 in projects over the ten-year planning period. Most of the projects proposed are possible because of special funding available for areas such as streets, transportation, and parks as well as the issuance of 2001 Wastewater Revenue bonds.

On the following page is a table containing FY 2004/2005 project appropriations by fund.

| *Project Expenditures by Fund* | | |
|---|---|---|
| **Fund** | **FY 2004/2005 Recommended Budget** | **10 Year Recommended Budget** |
| Infrastructure Renovation & Replacement | 1,149,130 | 26,990,729 |
| Utilities | 6,575,758 | 16,109,393 |
| General Fund | 1,050,145 | 10,761,608 |
| Capital Projects | 9,040,000 | 9,040,000 |
| Housing | 1,639,361 | 5,551,520 |
| SMaRT Station | 320,792* | 5,055,713* |
| Community Development Block Grant | 1,674,412 | 4,709,941 |
| Redevelopment Agency | 1,072,172 | 1,372,172 |
| General Services | 56,935 | 1,097,042 |
| Gas Tax | 24,753 | 736,855 |
| Park Dedication | 12,120 | 160,082 |
| Public Safety Forfeiture | 0 | 38,586 |
| Community Recreation | 0 | 8,500 |
| **TOTAL** | $22,615,578 | $81,631,821 |

*Adjusted to exclude the City's share of the SMaRT Station projects, which is budgeted in the Utilities Fund

Details of the projects budget are included in the *Major Project Efforts* section of this Transmittal Letter, in discussion of the individual funds, and in *Volume II Projects Budget* of the budget document.

## THE SUNNYVALE APPROACH TO BUDGETING

As we begin review of the recommended FY 2004/2005 Budget and Ten-Year Resource Allocation Plan, it is important to understand the key financial and planning systems that Sunnyvale uses to chart its future both in the good times and the bad times. Sunnyvale's approach to budget preparation is a central part of the City's Planning and Management System (PAMS). Key elements of the PAMS framework include:

- Long-range strategic planning (the General Plan Elements and Sub-Elements),
- Long-term financial planning (the Ten-Year Resource Allocation Plan, which includes projections over a 20-year time frame),
- Short-term allocation of resources (the two-year action budget),
- Outcome measurement of service delivery,
- The Council Study Issues process,
- Performance "contracts" for Management,
- Annual performance reporting and evaluation, and
- Performance audits based on risk assessments.

This integrated framework has enabled the City, over time, to accomplish the long-range strategic goals established by Council in the General Plan Elements and Sub-Elements. PAMS has assisted the City in maintaining, and even expanding, services during times of numerous Federal/State mandates and revenue restrictions or reductions. PAMS has also served as a valuable tool in producing and capturing remarkable gains in efficiency and productivity.

The Fiscal Sub-Element of the General Plan requires that the City Manager annually propose a budget that is balanced not only for the budget year, but also for the Ten-Year Resource Allocation Plan. Since FY 1993/1994, Council has approved a financial plan that has been balanced to the twentieth year. The long-term nature of the City's financial planning system allows decision-makers to better understand the true effect of policy decisions. Because City practice has been to prepare a fully balanced 20-year financial plan, it effectively requires that decisions made today guarantee that the resources will be available to provide quality services in the future. The Ten-Year Resource Allocation Plan prevents wild swings in service levels during the upturns and downturns of economic cycles.

Annual budget review and approval is a sound business practice and is required by the City Charter. However, an understanding of the City's long-term financial picture is more important to the process than just looking at a one-year or two-year snapshot. Therefore, much of the discussion in this Transmittal Letter will focus on long-term strategic planning and fiscal issues.

### OPERATING BUDGET PROCESS

Sunnyvale has practiced two-year budgeting for our operating programs for a number of years. This is in recognition of the tremendous effort needed to develop budgets, particularly with the City's sophisticated outcome-based budget system. In normal times, service levels remain relatively constant from year to year. By doing two-year budgeting, staff time is maximized and more in-depth review of each budget element can be accomplished.

As indicated earlier, FY 2004/2005 is the first year of a two-year operating budget cycle. Further, as the process started it was clear that the FY 2004/2005 Budget would need to continue the process of "changing our life style" that was begun last year in response to our new fiscal realities.

**City Manager Budget Review**

Beginning in the Fall a careful review of all elements of the operating budget was conducted with each department and program manager to ensure that resources are aligned with desired outcomes. A pre-review was first conducted by Finance staff and then an extensive review was undertaken with the City Manager. These reviews were based on the actual resources that were used to produce the desired outcomes in FY 2002/2003. That is, if the outcomes were successfully accomplished in FY 2002/2003, the level of resources that was actually used was assumed to be sufficient and formed the basis of the allocation for FY 2004/2005. The Sunnyvale budgeting approach uses hours needed to accomplish a particular activity at a desired level and is not based on Full Time Equivalents ("FTEs.") The review also included actual and projected number of products (units of service) and cost per hour in delivering that service. This approach, while extremely time-consuming, allowed us to take advantage of a number of cost savings, efficiencies, and changes in service demand. These resulted in reductions to many program budgets which are already reflected in the base Recommended FY 2004/2005 Budget. In some cases, resources are less than the current budget.

A number of other components of the operating budget were analyzed and updated to reflect current conditions. Rental rates and salary additive rates for the internal service programs were reviewed, with new rates applied to recover costs. Current salary levels for City employees were adjusted based on existing Memoranda of Understanding or estimated salary increases. For enterprise funds, significant cost components, such as purchased water, chemicals or landfill charges were updated with current information, and utility rates were adjusted as appropriate. Additionally, revenue sources were updated for all funds.

## PROJECTS BUDGET PROCESS

In the City of Sunnyvale the term "project" refers to non-operating activities. Beginning in FY 1999/2000, the City segregated each project into one of four possible categories: Capital, Special, Infrastructure and Outside Group Funding. These categories are defined as follows:

**Capital Projects** are major expenditures related to construction, improvement or acquisition of capital assets. This category includes feasibility studies, preliminary plans and other projects that are related to design, construction, capital improvement or acquisition. The construction of a traffic signal would be a capital project. Other examples include adding a room to an existing facility (capital improvement) or purchasing a piece of property (acquisition).

**Special Projects** are one-time only in nature and are set up to eliminate the impact that such costs would have on unit costs in operating programs. This category includes studies and other projects that are not related to construction, capital improvements, renovation/ replacement or acquisition of a capital asset. For example, the preparation of a new sub-element of the General Plan would be a special project.

**Infrastructure Projects** are inherently related to capital projects. This category includes the renovation and/or replacement of a capital asset. After a capital project is complete, the City has an asset that must be maintained through the operating budget until the asset reaches a point where maintenance costs exceed renovation/ replacement costs. An infrastructure project is developed in order to provide future funds at the time that replacement or renovation is required. An example would be the replacement of major components of the Water Pollution Control Plant or the replacement of the Heating, Ventilation and Air Conditioning (HVAC) system in City Hall.

**Outside Group Funding Projects** are essentially special projects; however, they are established to identify contributions made to local community-based organizations.

As part of the process for budgeting capital and special projects, staff identifies all on-going operating costs that will need to be included in future years upon the completion of a given project. These costs are reflected on each Long Term Financial Plan in the *Current Requirements* section under *Project Operating Costs*. Consideration of this information enables decision-makers to evaluate the complete cost of proposed actions. This prevents the City from adding assets or activities that are not sustainable over the long term.

As mentioned earlier, the City's process for budget preparation places the project budget on a two-year cycle alternating with the operating budget. FY 2004/2005 is an "off year" for the project budget cycle, and therefore the review that was conducted was focused principally on new items or those that had a significant change in cost or in scope. Additionally, this year the City Manager asked the Public Works Department to lead a citywide effort to identify all potential future capital and special projects, whether funded or unfunded throughout the 10 -year Capital Improvement Program. This process, which resulted in an inventory of some 198 projects totaling approximately $200 million is described in more detail in the *Future Fiscal Issues* section of this Letter of Transmittal.

## OUTCOME-BASED BUDGETING

The outcome management system is an important part of Sunnyvale's Planning and Management System ("PAMS"). The City began to implement the outcome management system in FY 1995/1996 as part of a continuing effort to improve PAMS. Many of the operating programs included in this recommended FY 2004/2005 Budget have migrated to the outcome management system. Those which are not yet transitioned to outcome management are the programs in the Office of the City Attorney, the Human Resources Department, the Department of Employment Development ("NOVA") and two small parking district programs in the Public Works Department.

This year, the City Manager reviewed all outcome and performance measures included for both programs and service delivery plans ("SDPs"). The work was completed as part of the City Manager's review of the budget requests submitted by departments. Changes were made to the wording of some measures to better describe the intended outcomes, or to the planned performance levels to better reflect the actual performance levels that have been already achieved. These changes will be reviewed as part of the presentation of the recommended FY 2004/2005 Budget and Ten Year Resource Allocation Plan at the May 25, 2004 budget workshop. In addition, Council approved 14 program restructures during the past year. These included the following programs:

**Public Works Department**
Roadside and Median Right-Of-Way Services
Concrete Maintenance
Urban Forestry Management

**Public Safety Department**
Police Services
Fire Services
Community Safety Services
Personnel and Training Services
Special Operations
Technical Services
Public Safety Administration

**Office of the City Manager**
Neighborhood and Community Services
Volunteer Resources

**Information Technology Department**
Information Technology Services Delivery
Application Development and Support

Council has indicated that it would like to see staff complete a comprehensive review and analysis of the outcome management system. One result of this analysis would be to change the system so that outcome measures can be more directly tied to the level of resources allocated to a program. Originally, this work was going to begin during FY 2003/2004. However, in February 2004 as part of the new process to prepare the recommended budget, Council agreed to postpone this work until next fiscal year. This allowed staff in the Office of the City Manager and the Department of Finance to focus their efforts on the new budget process.

The review and analysis of the outcome management system will be conducted in FY 2004/2005. The project will compare the original intent and objectives of the outcome management system with results achieved to date. It will also identify Council's current expectations for this system. System improvements or changes to meet current expectations will be identified. Information and training manuals and modules will be prepared.

## BUDGET FORMAT AND AWARDS

Sunnyvale has an extremely complex and detailed budget preparation, review and adoption process. Staff has traditionally presented to Council the City Manager's recommended Budget in the form of a workbook. This workbook is used to guide the Council through the budget workshop, the public hearing and finally the official adoption of the budget for the upcoming fiscal year.

The recommended Budget document is divided into three volumes. *Volume I* includes the *City Manager's Transmittal Letter*, *Budget Summary*, *Long-Term Financial Plans*, *Revenues*, and *User Fees.* Also included in this volume is the *Budget Supplements* section, which includes the various budget reductions that were considered in balancing the recommended FY 2004/2005 Budget. *Volume I* is useful as a summary document, with more detailed information found in the other three volumes.

*Volume II Projects Budget* contains all of the City's capital, infrastructure, special and outside group funding efforts. This volume begins with a *Projects Budget Guide* that describes what a project is in the City of Sunnyvale and how projects are prioritized in the budget process. This volume receives detailed attention during the "on year" for projects, which was FY 2003/2004.

*Volume III Operating Budget* contains all of the City's programmatic efforts. This volume also begins with an *Operating Budget Guide* that describes Sunnyvale's unique Planning and Management System. The Operating Budget is organized around the seven elements of the General Plan. Each element contains the General Plan's Goals, Policies and Action Statements, Community Condition Indicators, and the budget of each operating program that is tied to that particular element. This volume receives detailed attention during the "on year" for operating, as is the case for FY 2004/2005.

In prior years staff has received positive feedback from Council members and citizens regarding the Budget-in-Brief booklet. This is an effort to highlight the important aspects of the particularly large and complex recommended Budget document. This year, staff will again prepare this summary containing the City Manager's Transmittal Letter and Budget Summary.

In December 2003 the Department of Finance was notified that the City's adopted FY 2003/2004 Budget and Ten-Year Resource Allocation Plan had received the Distinguished Budget Presentation Award from the Government Finance Officers Association ("GFOA"), a national organization of finance professionals. This award program, established in 1984, "recognizes exemplary budget documentation by state, provincial and local government, as well as public universities and colleges." The City has received this award for 15 consecutive years. In addition to qualifying for the award this year, our Budget received the special recognition "outstanding as a policy document," which is the highest rating that can be received in that category.

## FISCAL YEAR 2004/2005 BUDGET

## OVERVIEW

I am pleased to present a balanced budget for this upcoming fiscal year. The Ten-Year Resource Allocation Plan and 20-year financial plan are in balance as well when coupled with the financial strategies that have been developed for Council's consideration as we address our ongoing structural imbalance between revenues and expenditures. In fact, if all of the financial strategies were successfully implemented, the long term financial picture would provide the City financial flexibility in the second ten years.

Table I, below, is a summary of the recommended expenditures for all City funds. This table provides a comparison of the recommended Budget for FY 2004/2005 and FY 2005/2006 with the current fiscal year and the latest actual fiscal year.

***Table I Recommended Expenditures – Citywide****

| Expenditure | 2002/2003 Actual | 2003/2004 Revised Budget | 2004/2005 Proposed Budget | % Growth 2004/2005 over 2003/2004 | 2005/2006 Proposed Budget | % Growth 2005/2006 over 2004/2005 |
|---|---|---|---|---|---|---|
| Operating | 144,492,061 | 150,473,059 | 162,758,676 | 8.16% | 171,105,554 | 5.13% |
| Projects | 40,772,618 | 71,673,649 | 24,172,636 | (66.27%) | 10,401,832 | (56.97%) |
| Lease Payments | 1,215,678 | 1,216,678 | 1,545,330 | 27.01% | 1,554,168 | 0.57% |
| Budget Supplements | 0 | 0 | 4,500 | NA | 0 | NA |
| Fiscal Strategies | 0 | 0 | (1,100,000) | NA | (2,618,090) | NA |
| SMaRT Station Expenses** | 15,551,825 | 16,287,719 | 16,286,860 | (0.01%) | 16,754,536 | 2.87% |
| Debt | 6,574,679 | 6,760,951 | 6,824,438 | 0.94% | 6,814,180 | (0.15%) |
| Equipment | 0 | 300,000 | 0 | | 0 | |
| **SUB-TOTAL** | **208,606,861** | **246,712,056** | **210,492,440** | **(14.68%)** | **204,012,180** | **(3.08%)** |
| Employment Development Grant Programs | 13,230,740 | 12,548,062 | 10,060,213 | (19.83%) | 10,081,213 | 0.21% |
| **TOTAL** | **221,837,601** | **259,260,118** | **220,552,653** | **(14.93%)** | **214,093,393** | **(2.93%)** |

* This table excludes internal service funds, which are reflected as rental and additive rates in the Operating expenditure line.

** The SMaRT Station Expenses represent Mountain View and Palo Alto's shares of SMaRT Station expenses. Sunnyvale's share of expenses is represented in the Operating expenditure line.

The overall recommended FY 2004/2005 Budget is 14.93% below the adopted FY 2003/2004 Budget. However, the inclusion of the Employment Development Grant programs and project-related expenditures can be misleading when making year-to-year comparisons.

The recommended FY 2004/2005 Budget for operating-related expenditures is 8.16% higher than the Revised FY 2003/2004 Budget. In general, the increases are attributable to increases in the cost of salaries and benefits and certain purchased goods and services such as purchased water. The individual components of the increases for each fund will be discussed the *Detailed Fund Reviews* section of this Transmittal Letter.

As you may note, the project line item has seen a dramatic decrease from FY 2002/2003 Actual and FY 2003/2004 Revised Budget to the recommended FY 2004/2005 Budget. Again, this type of yearly comparison is difficult to make because of the one-time nature of projects. There are two reasons for the apparent decline.

First, the large apparent increase in the FY 2003/2004 Budget is due to the carry over of funds for projects that were budgeted in earlier years but not yet completed. Because projects are often multi-year in nature, project funds are often carried over from year to year. This can be seen in the FY 2003/2004 Revised Budget number of $71.67 million for projects. Of this amount, approximately $48.7 million represents carryover of funds for projects in progress from FY 2002/2003.

Second, the overall reduction is due to the elimination of a number of projects as part of last year's budget reduction process.

While it is useful to understand the City's overall budget, it is important to underscore that the City's budget is comprised of multiple funds, with the real short-term and long-term position of the City contained in the respective position of each of these funds. This Transmittal Letter will discuss each fund in detail, but places emphasis on the General Fund.

Finally, any long-range financial or strategic plan must make certain assumptions in establishing the basis for projections. The next section discusses the assumptions that staff has developed for this particular recommended Ten-Year Resource Allocation Plan and its accompanying 20-year financial plan.

## BUDGETARY INFLATION FACTOR

Inflation of purchased goods and services for the recommended Ten-Year Resource Allocation Plan and 20-year financial plan is assumed to be 1% for FY 2004/2005, 2% per year for the remainder of the first ten years, and 3% for the second ten years. Certain selected budget components, such as purchased water, gasoline, or electricity are increased (or decreased) according to their individual cost characteristics.

Salary projections are based on current memoranda of understanding ("MOU"s) with employee associations, with estimates for FY 2004/2005 provided by Human Resources staff after review of each respective salary formula. Assumptions for employees represented by the Public Safety Officers Association (“PSOA”) are that salaries will increase by 3.4% for FY 2004/2005, 4.1% for FY 2005/2006, 3% through FY 2013/2014, and then 4% thereafter. For Sunnyvale Employees Association ("SEA") members and Management employees it has been assumed that salaries will increase 2.1% for FY 2004/2005, by 3% through FY 2013/14, and by 4% thereafter.

Projections for major revenues are based on detailed analyses of their unique characteristics and therefore they do not necessarily reflect a simple inflation pattern. The assumptions for each major revenue source will be detailed in the discussions of each appropriate fund.

The budgetary inflation assumptions mentioned above are particularly significant since the City utilizes multi-year financial planning over a twenty-year period. Small changes can have a significant long-term effect. For example, a $1 million loss in revenue or a $1 million increase in operating expenses in an assumed 3% inflation environment amounts to a cumulative $26.87 million change in position over the entire planning period.

# FUTURE FISCAL ISSUES

Midway through each fiscal year, a Council Study Session is held that identifies factors in the City's current environment and in the near-term that could impact our fiscal security. This year, the Study Session was held on February 10, 2004. The purpose of the Study Session was to:

- Provide Council with an update on the City's current financial condition, including revenue and expenditure patterns and give an economic forecast for the State in general and Silicon Valley in particular
- Identify the possible actions by the Federal Government, State of California, and regional agencies that will affect Sunnyvale
- Identify and briefly discuss several local issues to examine as the annual budget and long-term financial plan is being prepared
- Receive from Council issues, questions, and initial policy direction that will need to be incorporated into the annual budget.

Below are discussions of the major areas covered in the Future Fiscal Issues Study Session.

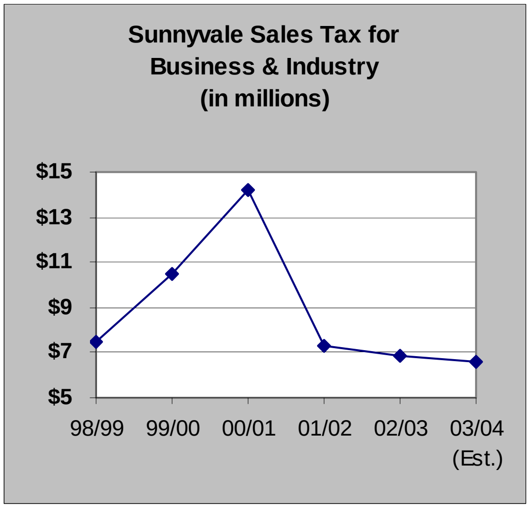
## CURRENT ECONOMIC CONDITIONS AND OUTLOOK

Just four years ago, the nation was in the longest economic expansion in U.S. history. The Silicon Valley was booming and Sunnyvale's finances were buoyed by significant increases in General Fund revenues. Since that time a number of events have occurred nationally and locally that have dramatically altered our financial position.

On a national basis, the U.S. economy decelerated sharply beginning in late 2000 after experiencing nearly ten years of sustained economic growth. Gross domestic product ("GDP") growth slowed from over 5% in the first half of 2000 to 1.4% by the fourth quarter of the year. After September 11$^{th}$ the downturn intensified. Especially significant for Sunnyvale and Silicon Valley was the dot.com bust and resulting spillover effects of reduced business expenditure on computer hardware and software. This condition continues to persist in 2004, though cautious optimism for a sustained, albeit slow, recovery has emerged in Silicon Valley.

Since the economic downturn began, the Silicon Valley has lost approximately 200,000 jobs. To better put this into perspective, one noted California economist has said that if measured in terms of job loss, what we are experiencing here is on par with losses suffered during the Great Depression. After falling to record lows of around 1.3% in 2000, unemployment in Silicon Valley stands at 6.8% versus 5.6% nationwide. Some areas in the Valley currently are experiencing unemployment rates between 8% and 11%. Due to the tech-heavy concentration in our region and the resulting permanent loss of jobs, unemployment will likely remain higher here than the rest of the country for the near future, further slowing the pace of an economic turnaround.

## Effect on Sunnyvale Revenues




One result for Sunnyvale has been a decline in General Fund revenues, fueled by sharp drops in Sales Tax and Transient Occupancy Tax ("TOT") receipts. By the end of FY 2001/2002 Sales Tax and TOT revenues dropped by 30% and 40% respectively from the records highs of FY 2000/2001. Initially, revenue projections for these and other revenue sources anticipated a leveling out in FY 2002/2003, but it now appears that the bottom will occur sometime in FY 2003/2004. For example, TOT is expected to be 11% lower than projections, and Sales Tax revenues are trending to be approximately 5% lower than budgeted in the current fiscal year. Overall, we expect to receive approximately $84 million in General Fund revenues in FY 2003/2004, or 4.5% less than actually received in FY 2002/2003.

## Projected Pace of Recovery: Positive Signs but Job Growth Lagging

The basis for a projected pace of recovery begins with the premise that the intensity of the Silicon Valley technology boom in 2000 was in all likelihood an anomaly that may not ever be repeated. As the previous graph on Business and Industry Sales Tax revenues illustrates, Sunnyvale Sales Tax in the Business and Industry sector spiked by nearly 90% from FY 1998/1999 to FY 2000/2001, before sharply returning to early 1998 levels in FY 2001/2002. This sector sustained further losses in FY 2002/2003, with actual revenues dropping below $7 million for the first time since FY 1990/1991. In FY 2003/2004 it is anticipated that losses will stabilize and begin to rebound in FY 2004/2005. Not coincidentally, this sharp spike parallels the huge increase and subsequent drop in State General Fund revenues that was largely fueled by capital gains and stock options.

The one consistent theme from economists is that a recovery here and across the nation will be modest and slow. Unemployment in the region remains higher here than other areas in the State and across the country, but there are positive signs in the form of gains in earnings reports and local stocks, significant increases in sales from select technology companies, decreasing availability of office space for lease, and a continued strong housing market. Due to the tech-heavy emphasis in our region and the resulting losses in jobs, productivity and sales, the recovery here is lagging the state and the rest of the country. While many other areas in California are experiencing a modest growth in Sales Tax and other revenues, Silicon Valley has not yet seen an appreciable and sustained upturn.

If positive signs for continued economic recovery exist in Silicon Valley, they are somewhat tempered by the jobs growth picture. While recent reports suggest that the nation is adding an average of approximately 200,000 new jobs monthly, this rate will not be duplicated in our region for the foreseeable future. The high concentration of tech-related job losses, coupled with such trends as the off-shoring of high tech jobs, has produced structural rather than cyclical unemployment. With cyclical unemployment, job loss is mainly due to drop in demand. As economic recovery occurs, job growth tends to be steep. Conversely, structural unemployment occurs when an industry changes fundamentally as a result of more permanent or pervasive drops in demand, improvements in technology or the movement of production overseas. The manufacturing sector in the Silicon Valley has experienced this type of unemployment. On the positive side, many economists believe that job loss in the Bay Area has stabilized and that modest job growth will occur over the next two years. On the negative side, it is believed that little job growth will occur in Santa Clara County, which sustained approximately 50% of the job loss in the entire Bay Area due to the tech-heavy concentration in the region.

**STATE BUDGET SITUATION**

Less than four years ago, the State government was anticipating a budget surplus of up to $13 billion. In a stunning reversal of fortune, the State's budget deficit was projected to be a staggering $35 billion deficit by the end of FY 2003/2004. This leads to the question: Where did all the money from the good times go? There are three main answers to this. First, State revenues sharply declined, largely due to decreases in personal income tax from capital gains and stock options. Second, as State revenues were growing throughout the 1990s, so were expenditures. From FY 1993/1994 to FY 2000/2001, State spending more than doubled, from $39 billion to $79 billion. The third reason lies in unplanned expenses, chiefly the fact that the State did not anticipate well, or recover well, from costs related to the energy crisis of 2000. The result of these converging factors is that the State has a significant ongoing structural deficit that will not disappear without corrective action. The State Legislative Analyst estimated in early 2004 that the State's budget deficit would reach $17 billion in FY 2004/2005, nearly 90% of which relates to the ongoing structural imbalance.

In October 2003 an additional measure of uncertainty for the State's fiscal picture came into play with the recall of democratic Governor Gray Davis in favor of moderate Republican Arnold Schwarzenegger. This historical event marked the first time in California history that a sitting Governor was recalled (and only the second time in US history). Since Governor Schwarzenegger took office, there have been many complicated developments regarding the State's fiscal issues, certainly too many to list here. The Governor has vigorously pursued budget reduction strategies on a number of fronts, seeking to broker deals with various constituencies, including local governments. Below is a summary of the major actions already taken and to be taken that will impact local governments in general and Sunnyvale in particular.

One of the first actions by newly-elected Governor Schwarzenegger was to repeal the Vehicle License Fee (VLF) increase invoked by the previous administration. The VLF is a constitutionally guaranteed local revenue source, a major portion of which is "backfilled" to cities after it was legislatively reduced in the 1990s. Elimination of the backfill would mean an annual revenue loss of nearly $6 million to Sunnyvale. The VLF was originally reduced by the Legislature with the proviso that if the State could no longer afford the backfill, then a "trigger" would be pulled to restore the VLF to previous levels. After legal review in late 2002, the Democratic administration concluded that the State's Finance Director could "pull the trigger" without invoking the voter approval requirements of Proposition 218. The trigger was then pulled at the end of FY 2002/2003. Due to lag time associated with implementing the statewide increase in VLF, a "backfill gap" was created whereby local governments lost approximately 100 days of VLF backfill revenue (which the State promised to repay in 2006). For Sunnyvale this translated into an approximate $1.8 million loss in FY 2003/2004. The repeal of the VLF increase immediately put $6 million in Sunnyvale General Fund revenues at risk, but Governor Schwarzenegger vowed to make cities whole for the loss and restored the backfill process in December.

While local officials greeted the Governor's December promise to backfill VLF revenues to cities with relief, such solace was quickly dispelled with the unveiling in January of the recommended FY 2004/2005 State budget. The proposed budget included <u>permanent</u> cuts to local governments, mainly through a new property tax shift similar to the Educational Revenue Augmentation Fund ("ERAF") shift implemented during the 1990s. In addition, further cuts were proposed to supplemental law enforcement and transportation funding, property tax associated with redevelopment agencies, public library grants, and continued deferral of State mandate reimbursements. The revenue loss to Sunnyvale of this budget proposal is estimated to be nearly $3 million annually to the General and Redevelopment funds.

In March 2004, California voters approved the Governor-sponsored Propositions 57 and 58. This paved the way for the historic $12.3 billion deficit-reduction bond issue known as the "Economic Recovery Bonds," the sale of which has been partially completed. In addition to the bond issue, passage of the propositions will also amend the State Constitution to 1) require annual budget adoption by the Legislature, 2) give additional mid-year budget adjustment powers to the Governor, 3) establish minimum and specific reserve requirements, and 4) place restrictions on future deficit-related borrowing. The bond issue involves a complicated, three-step local Sales Tax for Property Tax swap called the "Triple Flip." This mechanism is discussed in more detail in the *General Fund* section of the *Detailed Fund Review* portion of this Transmittal Letter. In brief, the triple flip diverts ¼ cent local Sales Tax to fund the repayment on the bonds. In return, local governments will receive an equal amount of Property Tax to cover the Sales Tax loss. Though the tax swap is supposed to be cost-neutral to local governments, cities may experience cash flow problems because Sales Tax is apportioned monthly while the majority of Property Tax is apportioned bi-annually. Local governments will also lose some interest earnings on the diverted Sales Tax. Perhaps more ominous for cities, the Sales Tax diversion marks the first time the State has moved to take this most important local revenue source (and a major locally-controlled revenue source that has heretofore been "off-limits" to State lawmakers).

**Local Taxpayers and Public Safety Protection Act**

As the State seeks once again to balance its budget with local revenues, the League of California Cities ("LCC"), California State Association of Counties ("CSAC"), the California Redevelopment Association ("CRA") and the California Special District Association ("CSDA") have formed a coalition (the "LOCAL Coalition") to place a ballot initiative on the November 2004 ballot that would amend the Constitution to permanently protect local revenues. Known as the "Local Taxpayers and Public Safety Protection Act" or the LOCAL initiative, the ballot measure would require a majority vote of the people before the State could take and use local government funds. It would also strengthen existing law to require timely reimbursement to local governments for State-mandated programs, services or other added costs. If passed, the LOCAL initiative will increase local control over local tax dollars so that funding for critical services is more dependable and predictable. Having gathered more than the required amount of petition signatures, local governments are awaiting final certification from the Secretary of State to guarantee placement of the initiative on the November 2004 ballot. The Council approved a resolution on November 11, 2003 to support the LOCAL initiative.

**New Budget Deal for Local Governments**

The Governor has engaged LCC, CSAC, CRA and CSDA in discussions to secure legislative and voter approval of a proposed alternative November 2004 Constitutional amendment that would provide equal, or better protection than the LOCAL initiative. The Governor has pledged his full support to secure passage of this alternative ballot initiative in exchange for two years of funding cuts totaling $2.6 billion to cities, counties, special districts and redevelopment agencies. For Sunnyvale, this would mean the loss of approximately $4.1 million to the General Fund and $528,000 to the Redevelopment Agency over the next two fiscal years. This alternative is in place of the permanent reductions contained in the Governor’s January 2004 proposed budget. Additionally, the new proposal guarantees repayment in 2006 of the VLF monies taken during FY 2003/2004. This repayment amounts to $2.4 million for Sunnyvale. The net effect of the proposed deal is $1.7 million to the General Fund and $528,000 to the Redevelopment Agency Fund.

Although the LOCAL initiative would remain on the November 2004 ballot, all efforts by local governments would be re-focused on passage of the Governor’s alternative proposal. In the second week of May the LOCAL Coalition members ratified the proposed budget deal and it has been included in the Governor's May Revision of his FY 2004/2005 Budget. It is important to remember that if the LOCAL Coalition had not accepted the Governor's Proposal, the Governor has indicated that he would oppose the LOCAL Initiative. This action would definitely jeopardize its passage.

The Governor’s proposed budget deal with local governments is promising for a number of reasons: it limits the revenue loss to two years; it guarantees the VLF repayment in 2006; and most importantly it provides support for our constitutional protection of local revenues. Still, the deal must be approved by the Legislature, which has already expressed concerns that the Governor is making promises the State may not be able to keep. As indicated earlier in this section, the Governor has also struck similar deals with other constituencies, namely higher education, that will require legislative approval. The concerns of the Legislature may in fact be well founded, as the State still faces a significant structural budget imbalance that will not disappear without corrective action. Full details of the Governor's revised budget for FY 2004/2005 were released on May 13, 2004 and provisions of the deal have been incorporated into our recommended FY 2004/2005 Budget and Long Term Financial Plan.

**Other Budgetary Impact for Cities in May Revise**

In addition to the major budget deal discussed above, certain other changes to state funding for local programs were included in the Governor's May Budget Revision. The Public Library Fund suffered a ten- percent reduction in funding. This amounts to about $6,000 for the City of Sunnyvale. It should be noted that this State grant source has been reduced by about 72% in the two previous years. In keeping with our standard practice with grant funds, we do not include the Public Library Fund ("PLF") funds in the budget on an ongoing basis, but rather appropriate them as they are received. Therefore, there is no immediate impact to the recommended FY 2004/2005 Budget but there will, of course, be a reduction in supplemental library programs available as a result if PLF funds are lower.

While the Governor's original budget proposed in January did not reduce Supplemental Law Enforcement ("SLES") funding to cities, the current May Revise suggests that these funds be used to pay mandate claims for Police Officers Procedural Bill of Rights first, with any remaining funds granted to cities. This recommendation would most likely reduce our SLES funds, which are currently supporting one Patrol Watch Commander in the Department of Public Safety. A discussion of this situation is contained in the *Police Services Augmentation Fund* section of the *Detailed Fund Reviews* in this Transmittal Letter.

The May Revise does not address booking fees. The League of California Cities is assuming that this means that the January proposal, which removes the booking fee subvention to cities and the authority of counties to charge booking fees, is still in place. This would actually be of benefit to the City, since we have currently included the cost of the booking fees in the Department of Public Safety operating budget but have removed the state subvention for these fees from our revenue projections. The actual benefit would be approximately $178,000 in reduced costs. Currently there are several bills regarding booking fees being considered in the Legislature and the issue is not resolved. When a direction is clear, staff will bring an adjustment to the Budget back to the Council if needed.

## LOCAL ISSUES IMPACTING THE CITY'S FINANCIAL CONDITION

At the Future Fiscal Issues Study Session in February, four current issues in addition to the items mentioned above were identified that will have a significant effect on the City's financial condition now and in the future. These issues are briefly described below and will also be discussed in later portions of this Letter of Transmittal.

**Downtown Redevelopment**

The Downtown Redevelopment Project is in the midst of its highest level of development activity since it was created in 1975. The 460,000 square foot Mozart office development was completed in 2002. The City and CalTrain partnered to rebuild the CalTrain Station and to construct a 400-space parking structure, completed in May 2003. The 1.6-acre Downtown Plaza, a major new public facility, will open this summer.

The Forum Development Group of Smyrna, Georgia proposes to completely redevelop the moribund Town Center Mall into an open air shopping, office, and retail center. Major portions of the original street grid are proposed to be reconstructed, including Murphy Avenue, McKinley Avenue, and Taaffe Street. This will integrate the Mall block into our historic Downtown. In addition to the existing Macy's and Target stores, Forum proposes to build 570,000 square feet of new shops, 150,000-275,000 square feet of office space, and 200 to 300 for-sale housing units. Council action on Forum's proposed development plan is anticipated around July/August of 2004.

Once completed, the redevelopment of the Town Center Mall will protect existing revenue streams at the site and will result in increased Sales Taxes and Property Taxes. Staff is currently examining the estimated new City revenue based upon the current plans being proposed by the Developer. Of course, more precise projections will depend upon any final action taken by the Council on this project.

The final piece in this phase of Downtown redevelopment will be the reconstruction of Town and Country Shopping Center. Although the property owners have not yet selected a developer, it is expected that redevelopment of the site will commence during the next five years. The recently adjusted Downtown Specific Plan permits 450 new housing units and 52,500 square feet of shops on this site. This development will also yield new Property Tax increment and increased Sales Tax to the City.

The proposed redevelopment of downtown may also result in increased operating costs for public safety, public works, and parks and recreation services. Operating costs associated with the Multimodal Station and the Downtown Plaza Park have been included in the recommended FY 2004/2005 Budget in programs managed by the Public Works and Parks and Recreation Departments, respectively. Any additional operating costs associated with redevelopment of the Town Center Mall will, again, require further analysis and refinement depending upon final action by the Council.

**Upcoming Negotiations with the City's Employee Associations**

The City's current Memorandum of Understanding ("MOU") with the Sunnyvale Employees Association ("SEA") expires on June 30, 2004. Both the City and SEA have indicated their intent to renegotiate the contract and discussions have begun. The SEA represents approximately 530 employees throughout the City and is our largest employee association, so any changes to the MOU will affect base wages and benefits for the majority of the City's non-sworn employees.

The Communications Officers Association ("COA") MOU expired on December 31, 2003 and was extended through December 31, 2004. COA represents approximately 19 employees of the Public Safety Department.

The City's Memorandum of Understanding with the Public Safety Officers Association ("PSOA") expires on June 30, 2006, and our MOU with the Service Employees International Union ("SEIU") expires on June 30, 2005.

## Capital Improvement Projects and Infrastructure Investment

In early 2004 the City Manager asked the Public Works Department to update the 10-year Capital Improvement Program ("CIP"). The purpose of this effort was to take a comprehensive look at both Capital Projects and Special Projects to better identify the future unfunded liabilities of the City. Earlier versions of the CIP did not paint a complete picture because they incorporated only those projects for which funding had already been identified. Additionally, there were many Special Projects such as rate studies, franchise service reviews, etc. that the City must conduct on a periodic basis. Historically, these had not been fully projected.

The update of the CIP required each Department to assess their known future obligations and to identify new projects (both funded and unfunded.) Some of these projects had been previously identified but had not been included in the 10- year CIP due to funding constraints. Other projects had not been listed in the CIP because, while the obligation was known, the timing and scope of the project could not be easily defined. The update of the CIP was intended to include all projects even when funding was not yet identified or the final scope was indeterminate so that future obligations could be better projected.

It should be noted that this effort yielded information on known or anticipated projects only. There are likely to be additional obligations that will be identified as the City performs more detailed condition assessments of our existing infrastructure. For example, it is anticipated that the Wastewater collection system and treatment facilities will generate additional projects as a result of further studies. Beginning in FY 2004/2005 an extensive review of our existing infrastructure renovation and replacement program will be undertaken, and it is expected that a number of new utility projects will be identified which will fully populate the 10-year CIP.

The complete list of unfunded projects that was developed by this effort is shown in this budget document in *Volume II Projects Budget* in the section titled *Unfunded Projects.* As indicated above, many of these costs are very rough estimates and are meant to portray a rough order of magnitude only. The total of these unfunded projects, approximately $200 million, represents a very significant potential unfunded liability of the City. A detailed review of all of these projects will be undertaken in FY 2004/2005 as part of the Projects Budget process.

**Workers' Compensation Insurance Costs**

The City currently is self-insured for Workers' Compensation claims, but carries excess insurance for claims over $275,000. Our insurance policy is in the last year of a three-year contract that was negotiated at very favorable rates. In the time since the contract was negotiated, the insurance market has experienced a steep rise in premium costs. Initial indications were that our costs for excess insurance in this area would increase by over $500,000, which would have a significant negative fiscal effect on the City.

Following the Future Fiscal Issues Study Session, Risk Management staff identified a number of insurance options at different levels of excess coverage. Staff review of the City's Workers' Compensation claims history led to the conclusion that we could increase our "deductible" to $500,000 and mitigate the potential increase in our insurance premium next year. More information on this issue is included in the *Detailed Fund Reviews* section of this Transmittal Letter in the discussion of the Employee Benefits and Insurance Fund.

## FISCAL STRATEGIES

One of the most powerful aspects of multi-year budgeting and projection is the ability to plan for the future. Small changes made now can avert large problems later. As the City addresses the fiscal issues and challenges identified in the previous section, it is clear that a number of different strategies must be undertaken to help us deal with the structural imbalance between revenues and expenditures that has developed in our Long-Term Financial Plan. The following fiscal strategies will position the City well to address the current imbalance so that quality services can be sustained in the years to come.

- **Use cost-effective technologies to increase productivity, enhance customer service and/or reduce the cost of service**
- **Leverage and partner with community groups, non-profit organizations, and where appropriate the private sector to maintain services and lower costs**
- **Ensure that we are good stewards of the City's infrastructure assets**
- **Don't sacrifice safety or quality of life**
- **Support diversity in all areas of the community**
- **Maintain core services but evaluate the appropriate level**
- **Build and emphasize the connection between the community and business**
- **Pay close attention to the financial impact of policy decisions made throughout the year**
- **Think strategically by emphasizing the multi-year effects of key decisions**
- **Explore alternative service delivery methods including contracting out**
- **Support a quality work force**
- **Manage the City's "Life Style" so that we can live within our means**
- **Stick to the knitting, focusing on issues that can make a difference**
- **Work with employee associations to identify ways to more effectively utilize City resources**
- **Investigate new and increased revenue sources**
- **Emphasize and build on the unique culture of Sunnyvale**

In addition to the strategies listed above, we have identified a number of action items in support of these strategies that can be explored during the coming year. Some of these concepts are Citywide, while others relate to a particular department or expenditure area. During the next fiscal year staff will be reviewing and analyzing many of these ideas to identify their potential for cost savings and efficiencies in our organization, or revenue increases. The focus will be citywide, rather than by department. As opportunities are identified, staff will report the results to Council. *Appendix A* of this Transmittal Letter contains a list of some of the ideas that will be explored in FY 2004/2005.

Council will be asked to give policy direction regarding these strategies and action items during consideration of the recommended FY 2004/2005 Budget to identify if there is any item that Council is not interested in exploring or there are any additional items that Council would like to add to the list to be studied.

# MAJOR PROJECT EFFORTS

Sunnyvale's projects budget is a complex document involving four separate and distinct categories of projects: capital, infrastructure, special, and outside group funding. The projects themselves are budgeted and accounted for in various funds, most notably the General and Gas Tax Funds, the Capital Projects and Infrastructure Funds, and the Utility Funds.

Major initiatives and actions have added to this complexity. For example, the City's remarkable infrastructure planning and funding efforts led to the creation of long-term projects to fund major renovation and replacement efforts. The City's debt financing strategies are also reflected in this area.

Additionally, the past few years have seen a marked increase in various grants and special funding sources available for specific project categories, such as parks and streets and transportation. These revenue streams include the Santa Clara County half-cent Sales Tax for transportation (Measure B), Traffic Mitigation Fees, State Park Grants (Proposition 12 and Proposition 40), and Park Dedication Fees. Unfortunately, with the State budget crisis much of the special funding for transportation from the State is at risk. More discussion on this issue is contained in the section on *Traffic and Transportation Funding* below.

Along with the new initiatives and funding opportunities, the City also has a number of challenges in the projects area. As was discussed earlier, a major inventory of all funded and unfunded capital and special projects was undertaken this year. This effort identified approximately $200 million of projects over the ten-year Capital Improvement Plan that are currently unfunded. A major focus for FY 2004/2005 will be to review our capital and infrastructure programs, revise the estimates as needed, and evaluate the unfunded projects as identified.

The recommended FY 2004/2005 Budget includes funding for a total of 330 projects in all categories over the Ten-Year Plan. This section discusses some of the special funding sources and provides information on the status of major project initiatives. Descriptions of recommended projects for each fund are included in the *Detailed Fund Review* section of this Transmittal Letter.

## SPECIAL PARKS FUNDING

### <u>Proposition 12 Funds</u>

The passage of the Safe Neighborhood Parks, Clean Water, Clean Air and Coastal Protection Bond Act of 2000 (Proposition 12) provided funds to cities on a per capital basis to be used for various local park and recreational lands and facilities. The allocation to Sunnyvale was $1.5 million. The City has already programmed about $1.3 million of these funds for a variety of park improvements. Approximately $250,000 remains to be allocated. These funds will be programmed in next year's two-year projects budget.

**Proposition 40 Funds**

The passage of a second bond measure under the California Clean Water, Clean Air, Safe Neighborhood Parks and Coastal Protection Act of 2002 (Proposition 40) made available to the City an additional $943,604 for park and open space projects beginning in FY 2003/2004. Council has appropriated $500,000 of these monies to be the City's contribution toward the creation of an historical museum to be constructed at Orchard Heritage Park in partnership with the Sunnyvale Historical Society and Museum Association. It is now recommended that the entire amount of these monies be used to supplement funding for the Downtown Plaza Park in place of General Fund monies. It is also recommended that Park Dedication Funds in the amount of $500,000 be allocated to the Historical Museum project in place of the Proposition 40 funds. This will provide more flexibility to the Sunnyvale Historical Society as it completes its design and fund raising for the project and allow monies to be returned to the General Fund for use in addressing our current financial problems. A Budget Modification recommending these changes will be presented to Council for consideration in June 2004. This Long Term Financial Plan reflects the effect of these recommendations.

**Park Dedication Fees**

When developers of multi-family housing do not dedicate land for use as parks, the City collects a fee in lieu of the land dedication. These Park Dedication Fees are then used to pay for park facilities. These fees recently helped to pay for the Fair Oaks Skateboard Park and will help to fund a variety of upcoming projects, including improvements to the playground at Ortega Park and the Downtown Plaza project at Evelyn Avenue and Frances Street. The City is currently experiencing a marked increase in new housing developments that are subject to paying Park Dedication Fees, and funds are accumulating in the Park Dedication Fund. As mentioned above, some of these monies will be reprogrammed in FY 2003/2004 to support the Downtown Plaza Park and the Sunnyvale Historical Museum project. More detail on these revenues can be found in this Transmittal Letter in the *Park Dedication Fund* section of the *Detailed Fund Reviews.*

## TRAFFIC AND TRANSPORTATION FUNDING

**Santa Clara County Measure B Pavement Management Program**

In November 1996 Santa Clara County voters approved Measures A and B. These measures provided for a new general Sales Tax within our county, with proceeds earmarked specifically for transportation improvements. Following an unsuccessful legal challenge by taxpayer groups, the County Board of Supervisors and the Valley Transportation Authority (VTA) established procedures for the allocation of funds in 1999. The City of Sunnyvale has been allocated approximately $7.7 million over a five-year period for pavement management-related capital projects from Measure B funds.

All Measure B funds have been appropriated. Work on a number of these projects is currently underway, with completion scheduled for the end of FY 2003/2004.

**<u>State Traffic Congestion Relief Program (AB 2928) and Proposition 42</u>**

The State Traffic Congestion Relief Program (AB 2928) was part of the budget trailer bill for the transportation finance package of the State's FY 2000/2001 Budget. As part of this finance package, approximately $1 billion from the State portion of Sales Tax on gasoline sales was slated to go directly to cities and counties for preservation, maintenance and rehabilitation of local street and road systems for the period FY 2000/2001 through FY 2005/2006. These new funds were allocated on a per capita formula. AB 2928 funds impose a maintenance of effort requirement that obligates the City to maintain a level of expenditures for street, road, and highway purposes equivalent to the average expenditures for FY 1996/1997, FY 1997/1998 and FY 1998/1999. In addition, a "use it or lose it" provision requires that the City expend these funds by June 30th of the fiscal year following the one in which they were received. The legislation also requires that the monies be held and accounted for in the City's Gas Tax Fund.

When the legislation was first passed, it was projected that the City would receive approximately $3 million under AB 2928. In October 2000 the City received funds in the amount of $949,530 representing the first disbursement of AB 2928 monies for FY 2000/2001. AB 2928 funds in the amount of $333,586 were received in FY 2001/2002 and $345,684 has been received in FY 2002/2003. This leaves funds in the amount of about $1.5 million unappropriated.

Due to the current State budget crisis, the recommended FY 2004/2005 Budget and Ten Year Resource Allocation Plan assume no further revenue from AB 2928 will be received by the City. Should any of these funds become available, staff will program them in future years.

In March 2002, a constitutional amendment that permanently shifts the sales tax on gasoline from the State General Fund to the Transportation Investment Fund created by AB 2928 was approved by the voters as Proposition 42. The effect of this action was to indefinitely extend the allocation of Traffic Congestion Relief Program funds to cities, counties, and transit agencies beginning in FY 2008/2009. Preliminary information indicated at the time of passage that Sunnyvale's annual allocation would be approximately $1.2 million. In the meantime, the State budget crisis has put these funds into question. The potential exists for Proposition 42 funds to be diverted from the originally intended recipients to other transportation priorities. City staff are closely monitoring the discussions and working to ensure that at least a portion of these funds will be available for the City's transportation needs. However, because of the uncertainty, these funds have not been programmed in the recommended FY 2004/2005 Budget.

**Traffic Mitigation Funding**

The City Council has adopted a Transportation Strategic Program as part of the Revenue Sources for Major Transportation Capital Improvement Projects Study Issue. The Transportation Strategic Program establishes a comprehensive funding program of revenue sources for major transportation necessary to support the City's land use plans.

Prior to the adoption of the Transportation Strategic Program, an interim funding mechanism was implemented for transportation mitigation of major land development. Known as the Cumulative Traffic Mitigation, this mechanism mitigates cumulative impacts of several major approved land developments as they relate to the Land Use and Transportation Element of the General Plan, and offsets the potential revenue loss that would result if the City waited until the Transportation Strategic Program was completed before implementing a fee or assessment. The interim Cumulative Traffic Mitigation has been replaced by the Traffic Mitigation Fee.

The adopted FY 2003/2004 Budget included projects funded from Cumulative Traffic Mitigation revenues. The recommended FY 2004/2005 Budget and Ten Year Resource Allocation Plan does not include any new projects funded by Traffic Mitigation Fees. Since the mitigation measures are not yet finalized or identified in the current capital program, these funds will be appropriated over the next several years as the projects are developed.

## INFRASTRUCTURE RENOVATION AND REPLACEMENT

Sunnyvale has traditionally provided funding in its operating budgets for optimizing maintenance of City infrastructure. Staff believes this to be the most cost-effective, long-term way to approach asset management.

Nonetheless, even with this proactive maintenance approach, eventually every infrastructure element reaches a point where maintenance is no longer a cost-effective strategy, and significant renovation and replacement is required. Additionally, recent budget cuts for maintenance activities for City street pavement and tree pruning will result in accelerated deterioration over time.

Planning for infrastructure requirements is no small undertaking. There are two reasons for the magnitude of the challenge. First, much of the infrastructure maintained by the City was never initially a cost to us. Most of the roads, streetlights, and utility lines were paid for by owners of the benefiting, adjacent properties at the time various areas of the City were developed. When major renovation or replacement is needed, however, this same source of revenue support is no longer available. Second, even during the time when local governments in California had considerable flexibility with revenue sources, the likelihood of gaining constituent support for tax increases or assessments for this purpose was not high. In today's far more constrained revenue raising environment, it becomes even more difficult.

Although funding of the renovation and replacement of the City's estimated $1 billion in infrastructure assets is an enormous challenge, it is also critical to the long-term quality of life and financial condition of the City. Because of this fact, the City has undertaken an unprecedented effort to plan for this eventuality with a comprehensive Long-Range Infrastructure Plan ("LRIP"). The City also has undertaken an effort to better identify all future project related liabilities. This year's budget contains information projecting needs over the 10-year CIP that includes information on projects where there is not current funding in place.

The original development of the LRIP was split into two distinct phases. The City completed Phase I of the LRIP by establishing the Infrastructure Renovation and Replacement Fund and incorporating full funding for the General/Gas Tax and Community Recreation Fund assets. However, since development of Phase I occurred several years ago, the original assumptions will need to be reviewed and updated as necessary. The assumptions to be reviewed will include verifying the inventory of assets, the useful life of assets and equipment, replacement costs, etc. This effort will be undertaken as part of the "on year" of the Projects Budget starting early in FY 2004/2005.

Phase II of the LRIP addresses fixed assets within the utility funds (Water, Wastewater, and Solid Waste). Staff has been identifying and inventorying utility-related fixed assets, and providing preliminary estimates for replacement costs and lifespans. Because the Solid Waste Management Fund contains only a few assets, staff was able to complete a financing plan for those assets in the current rate structure for Solid Waste fees. However, the Water and Wastewater Funds have a large number of varied assets, including water mains, water valves, reservoirs, sewer collection equipment, storm drains and the Water Pollution Control Plant, to name only a few. Assumptions for how much the replacement of these assets will cost and when replacement will occur are essential to forming choices for financing strategies.

In order to provide more realistic estimates, staff has been collecting data on how these fixed assets perform in varied conditions. The City's utility maintenance management database effort ("Maximo") began several years ago for this purpose. The resulting work product was to be incorporated into the Maximo database. Work proceeded slowly while assessment of Maximo and exploring implementation options with City systems progressed.

At the time of this writing, funding for the purchase, installation, set-up, ongoing maintenance and operation of Maximo has been removed from the City's Capital Improvement Program. This reduction in resources will defer the full establishment and implementation of the LRIP. At this time, the Water Pollution Control Plant has utilized Maximo for documentation of ongoing work on plant equipment as it is performed. Incorporation of historical data will be accomplished when possible. This same effort was planned for other utilities such as water mains, water valves, reservoirs, sewer collection equipment, and storm drains. However, this level of effort cannot be implemented until such time as Maximo (or a similar asset management system) can be put in place.

Meanwhile, increased political attention continues to be paid to the issue of deteriorating infrastructure. This will likely mean the development of intergovernmental programs that provide assistance in the areas of rehabilitation and replacement. This assistance could include low-interest loans from “infrastructure banks,” matching programs, and/or grant funding. Any financial assistance will help defray the effect of future infrastructure costs on our ratepayers. Continued diligence in defining the extent of our infrastructure needs will be critical as the City looks at sources of funding for replacement of our existing infrastructure.

## MATHILDA AVENUE RAILROAD OVERPASS REPLACEMENT AND RECONFIGURATION

The State of California Department of Transportation (Caltrans) inspects bridges throughout the state every other year for structural adequacy and functional operation. They have been doing this bi-annual inspection for many years and the reports are given to the City to address any corrective action that is documented. These reports are used as the basis for the City’s maintenance efforts on bridges and included as part of the overall infrastructure management program.

As per the latest Caltrans inspection report, the current Mathilda Avenue Railroad Overpass bridge design does not meet bridge pier clearance standards, deceleration lane design standards, shoulder width standards, and bridge railing standards. These deficiencies create potential hazards to the public, and present a potential liability issue for the City.

City staff has successfully secured federal funds with 20% local match for removing the deficiencies and improving traffic circulation on the bridge. The proposed bridge improvements include reconfiguring the off ramp to Evelyn Avenue to allow full access to Evelyn from southbound Mathilda Avenue. As an added benefit, this improvement can service the anticipated increase in traffic from southbound Mathilda Avenue to downtown Sunnyvale.

A conceptual layout of the improvement proposal with a preliminary cost estimate of $17.42 million for the project has been submitted to Caltrans for funding purposes. The requirement of 20% local match translates to a maximum federal share of $13.93 million with the City’s share of $3.48 million. However, Caltrans has indicated to City staff that a limit of $10 million of Federal Hazardous Bridge Rehabilitation Replacement funding is placed on this project at this time. This would require the City to commit to a match of $7.42 million. Caltrans has also indicated to City staff that increased funding requests are considered on a case by case basis. City staff is continuing to work with Caltrans to increase funding. An alternative has also been prepared by refining the proposed improvements, which reduces the project cost to $14.4 million. The 80% of the reduced cost still exceed the federal contribution of $10 million. Caltrans has given direction that design should proceed prior to applying for increased funding. The current schedule calls for design to be completed in January 2006.

The recommended FY 2004/2005 Budget includes the Mathilda Avenue Railroad Overpass project unchanged at the $17.5 million project cost. As design work and negotiations with Caltrans continue, this project estimate will be modified to reflect the actual funding level and funding sources.  As indicated above, additional City funds may be needed to fully construct this project.

## DOWNTOWN PLAZA PARK

The Downtown Plaza is currently under construction and will be completed shortly after the beginning of FY 2004/2005. This facility will be a unique open space resource for downtown Sunnyvale, designed to accommodate gatherings of up to 2,000 people for special events, but also designed to be a pleasant passive experience for the day-to-day visitor. Phase 2 of the Plaza is not currently funded; the Phase 2 project would construct water features, an overlook area, and public restrooms.

Total funds of $6,881,482 have been budgeted for this project, as follows:

| | |
|---|---|
| Park Dedication Fund | $4,631,482 |
| General Fund | $1,250,000 |
| Mozart Land Sale Proceeds | $1,000,000 |

In June a Budget Modification will be considered by Council that replaces the General Funds in this project with Proposition 40 funds in the amount of $943,604 and additional Park Dedication monies in the amount of $306,396.  This action will free up $1,250,000 of General Fund monies that can be applied to the City's current fiscal crisis.

Funds for operation and maintenance of the Plaza in the amount of $92,372 have been included in Program 265, Neighborhood Parks and Open Space Management, beginning in FY 2004/2005.

# DETAILED FUND REVIEWS

As noted earlier in the section on *Fiscal Year 2004/2005 Budget Overview*, City finances are actually composed of a number of diverse businesses accounted for in separate funds. The following review will provide strategic long-term, as well as important short-term, financial highlights for each individual fund.

## GENERAL FUNDS

The General Fund is used by the City to account for all financial resources except those required by law or practice to be accounted for in another fund. Due to the fact that operation of the Gas Tax Fund is inextricably intertwined with the General Fund, it is included in the General Fund discussion.

### General Fund

The General Fund supports many of the most visible and essential City services, such as police, fire, road maintenance, libraries, and parks and open space maintenance. General government support functions are also included in this fund, and their costs are apportioned through the use of in-lieu fees to other City funds. Because the General Fund receives the preponderance of its revenue from taxes, it has been the most affected by voter-approved initiatives and State legislative actions. As a result of such action over the past decade, revenues to the General Fund are significantly less than they would have otherwise been. Additionally, the state of the regional economy has a direct effect on the General Fund, as we can see from our current budget crisis.

The General Fund has a very close relationship with several other funds. Those funds are the Community Recreation Fund, the Youth and Neighborhood Services Fund, the Gas Tax Fund, the Internal Service Funds, the Capital Projects Fund, the Infrastructure Renovation and Replacement Fund, and the Redevelopment Agency Fund. In each case, the condition of these funds has a direct bearing on the General Fund due either to contractual relationships or because the General Fund is a primary or significant source of financial support. The relationship between these various funds, where appropriate, will be discussed as a part of the General Fund, as well as in the review of each of these individual funds.

#### *General Fund Revenues*

Revenue Estimation Methodology

All revenue assumptions and projections are reviewed and revised each fiscal year. Further, considerable analysis is undertaken to identify the key elements that impact our major revenue sources so that the projection methodology is reliable over the long-term. Historical data underscores the fact that a significant swing in revenues can occur due to economic cycles. From a low in 1990 to the high in 2000, the economy has produced very different revenue yields to the City in a number of major categories. Projecting revenues based on the high point of the economic cycle could overstate the City's financial position significantly for future years and could result in spending patterns that cannot be sustained. Conversely, projecting revenues from the lowest point of the economic cycle could understate the long-term financial position of the City and cause unnecessary service reductions.

Each revenue source has its unique characteristics that have been used to make projections. In general, estimates of actual expected revenue for each major source are used to calculate FY 2004/2005 figures. For the balance of the financial plan, however, projections are based on a defined business cycle for each revenue modified for present circumstances. Because these projections are based on historic trends and assumed business cycles, they will need to be closely monitored and corrected to reflect any change in patterns or circumstances.

The on-going national recession has resulted in steep declines in City revenues. Although staff programmed these declines into the City's long-term financial plan, the reduced revenues from many of the City's most important revenue sources "thinned out" our ability to absorb future revenue losses or increased costs. Key revenues have continued to decline this fiscal year but appear to be stabilizing.

<u>The Triple Flip</u>

As discussed above in the *State Budget Situation* section of this Transmittal Letter, the State has recently issued "Economic Recovery Bonds" as part of the solution to the State's record budget deficit. These bonds are secured by a mechanism called the "Triple Flip" which swaps local Sales Tax for Property Tax while the bonds are outstanding. The Triple Flip has three elements or steps:

- Flip Number 1: The State moves money from cities and counties to the State by raising the State Sales Tax rate by ¼ cent and reducing the local Sales Tax rate by an equal amount. In this way, consumers don't see a change in the Sales Tax rate that they pay.

- Flip Number 2: So that cities and counties aren't hurt, an equal amount of Property Tax is taken from the schools (the Educational Revenue Augmentation Fund) and given to the cities and counties.

- Flip Number 3: So that the schools aren't hurt, the State makes up their loss by giving them an equal amount of money from the State's general fund.

<u>When all of the flips are completed, everyone has the same amount of money as before</u>, but a substantial amount of the State's money will now be in a special fund to pay debt service on the bonds instead of in the State's general fund.

In mid May the State sold the first phase of the Economic Recovery Bonds and the actual Triple Flip will begin July 1, 2004. The exchange mechanism will be in place as long as the Bonds are outstanding, and it unwinds automatically when the Bonds are paid off. Although the final maturity of the Bonds is 2023, it is expected that they will actually be fully repaid in nine to ten years because of certain provisions in the bond covenants and in the Proposition that authorized them. First, all Sales Tax revenue must be used to pay debt service. Second, the State is required to begin setting money aside in a special reserve starting in two years, with half of the reserve used to pre-pay the Bonds. Assuming that the Sales Tax grows at a 5% rate, which is actually slower than the average over the last 20 years, the Bonds would be fully repaid in nine or ten years.

The recommended FY 2004/2005 Budget and Ten Year Resource Allocation Plan for the General Fund reflects the Triple Flip mechanism over a ten year period beginning July 1, 2004. Staff has reduced our Sales Tax projections each year by one-fourth and reflected it as a separate line called "Triple Flip - Sales Tax Reduction." This same amount is then added to the Property Tax projections in a separate line entitled "Triple Flip - Property Tax Increase." <u>In the Triple Flip, the Sales Tax/Property Tax swap is dollar for dollar based on the actual Sales Tax revenue collected and it does not actually increase the City's Property Tax base.</u> There is no net fiscal impact to the City of the Triple Flip. The major effect of this mechanism on the City lies in the fact that Property Tax is essentially remitted to us twice a year while Sales Tax is remitted monthly; this causes a reduction in our interest earnings and a potential cash flow problem. We have taken this effect into consideration in our interest earnings projections for the General Fund.

<u>Effect of State Budget Deal on Estimated Revenues</u>

Unlike the Triple Flip, the State Budget deal discussed above in the *State Budget Conditions* section of this Transmittal Letter has the effect of <u>permanently redistributing</u> two of the City's revenue sources. As described, the deal will permanently reduce the Vehicle License Fee ("VLF") rate from 2% to .65%, which is its current effective rate to the consumer. For the first year, the VLF that the City would have gotten at the 2% rate will be calculated and this amount will be added to our Property Tax base through transfers from the Educational Revenue Augmentation Fund ("ERAF"). In the following years, we will receive our portion of VLF revenues at the now -permanent low rate and our increased Property Tax base will grow according to current economic conditions.

This part of the State Budget deal has been reflected in the General Fund Long Term Financial Plan in an increase in Property Tax and a corresponding decrease in VLF starting in FY 2004/2005. The numbers were developed by first taking our original VLF projection and reducing it by 67.5%. This number, approximately $5.4 million, was then added to the Property Tax projection. In the following years, the new Property Tax base grows at our forecasted rates over the entire planning period. It should be noted that this permanent shift results in a financial loss to the City in two areas. First, since Property Tax is paid twice a year while VLF is paid monthly, there is a cash flow and interest earnings loss. Second, and most importantly, the Property Tax rate of growth that we have projected is lower than the growth rate of VLF revenues, and this has a negative impact on our Long Term Financial Plan overall. However, it should also be noted that the VLF is a relatively precarious revenue source that would probably be eliminated or reduced by popular demand in the near future. By reducing the rate, the State Budget deal takes this risk away from cities and guarantees our revenues through Property Tax.

The second part of the State Budget deal involves a two-year "contribution" of the City's revenues to the State to help solve its budget crisis. The League of California Cities has estimated that Sunnyvale will lose $2,076,879 in FY 2003/2004 and a similar amount in FY 2004/2005. One positive aspect of the deal, however, is that we will be guaranteed the <u>return</u> of the VLF funds that we lost in FY 2003/2004 to the State. This amount is projected to be $2,427,909. The two years of loss and the VLF return are shown on the General Fund Long Term Financial Plan in the *Current Resources* section in the line item "*State Budget - Reductions.*" <u>The net effect over three years is a loss of $1.7 million.</u>

**General Fund Major Revenue Sources**

Six key sources generate nearly 87% of the City's General Fund revenues. They are: Sales Tax, Property Tax, Transient Occupancy Tax, State Shared Revenues, Utility Users Tax/Franchise Fees, and construction-related taxes and fees. The current budget projected that revenues from many of these sources would stop falling this year and moderately increase over the next few years as the economy began a slow but measured rebound. While receipts from Property Tax and construction-related revenues have improved, during FY 2003/2004 we continued to experience decreases in our Sales Tax and Transient Occupancy Tax revenues. However, it does appear that a rebound in the Sales Tax has begun to occur during the last part of FY 2003/2004. We are cautiously optimistic that we have turned the corner during the fourth quarter of this year and will start to see more economic strength in FY 2004/2005 in our major revenue sources.

Table II, on the following page, reflects projected major sources of General Fund revenues for FY 2004/2005 and compares those sources with the FY 2003/2004 revised projections. FY 2002/2003 actuals are also included. Overall, our revenues are forecast to be about $8 million higher than we projected for the same period last year. Comparisons of forecasts for specific revenue sources are difficult to make because of the reshuffling of VLF, Property Tax, and Sales Tax revenues through the Triple Flip and the State budget deal.

| ***Table II Recommended Revenues – General Fund*** | | | | | | |
|---|---|---|---|---|---|---|
| Revenue Character | 2002/2003 Actual | 2003/2004 Revised Projection | 2004/2005 Proposed Projection | % Growth 2004/2005 over 2003/2004 | 2005/2006 Proposed Projection | % Growth 2005/2006 over 2004/2005 |
| Sales Tax | 22,766,997 | 21,400,000 | 22,740,513 | 6.26% | 24,183,538 | 6.35% |
| Triple Flip – Sales Tax Reduction | 0 | 0 | (5,685,128) | N/A | (6,045,885) | |
| Property Tax | 23,868,187 | 24,091,920 | 30,222,666 | 25.45% | 31,480,501 | 4.16% |
| Triple Flip – Property Tax Increase | 0 | 0 | 5,685,128 | N/A | 6,045,885 | |
| Transient Occupancy Tax | 5,094,489 | 4,578,119 | 5,034,831 | 10.00% | 5,538,315 | 10.00% |
| State Shared | 8,566,561 | 6,221,258 | 2,905,794 | -53.29% | 3,063,019 | 5.41% |
| Interest | 4,378,043 | 3,660,186 | 2,017,950 | -44.87% | 1,617,676 | -19.84% |
| Franchises | 5,226,408 | 5,393,252 | 5,336,106 | -1.06% | 5,430,801 | 1.77% |
| Utility Users Tax | 5,651,673 | 5,539,172 | 5,711,749 | 3.12% | 5,889,712 | 3.12% |
| Permits and Licenses | 3,133,125 | 3,654,247 | 3,685,368 | 0.85% | 4,063,572 | 10.26% |
| Inter-Fund Revenues | 1,938,887 | 2,125,687 | 4,335,621 | 103.96% | 5,418,820 | 24.98% |
| Prop. 172 Sales Tax | 1,262,240 | 1,200,000 | 1,275,120 | 6.26% | 1,356,090 | 6.35% |
| Other Taxes | 1,521,419 | 1,722,522 | 2,001,260 | 16.18% | 2,166,491 | 8.26% |
| Service Fees | 1,544,889 | 1,658,919 | 2,368,684 | 42.78% | 3,134,676 | 32.34% |
| Rents and Concessions | 1,193,457 | 1,029,328 | 1,390,018 | 35.04% | 1,462,991 | 5.25% |
| Fines and Forfeitures | 609,858 | 678,878 | 699,893 | 3.10% | 714,245 | 2.05% |
| Miscellaneous | 1,176,358 | 590,383 | 564,462 | -4.39% | 706,508 | 25.16% |
| Federal Government | 11,431 | 36,755 | 0 | N/A | 0 | N/A |
| State Budget Reductions | 0 | 0 | (2,079,879) | N/A | (2,076,879) | N/A |
| Fiscal Strategies | 0 | 0 | 1,750,000 | N/A | 1,802,500 | N/A |
| **TOTAL** | **87,944,040** | **83,580,626** | **89,963,156** | **7.64%** | **95,952,576** | **6.66%** |

In the following section, detailed discussions of the City's six major revenue sources will include explanations of the revenue forecasts for FY 2004/2005 and beyond. However, for several other revenue sources the comparison between revised projections for FY 2003/2004 and recommended projections for FY 2004/2005 shown on Table II needs some explanation.

The decrease shown in anticipated interest earned is the result of reserve balances being drawn down to balance the recommended FY 2004/2005 Budget.

The increase in projected Inter-Fund Revenues is due to accelerated payment schedules of a number of loans made by the General Fund to the Utility Enterprises, the General Services, and the Redevelopment Agency funds. Because of the cash flow problems of the General Fund, payments were increased or brought forward wherever possible in order to provide resources to the General Fund in the early years of the Long Term Financial Plan.

Revenue receipts from service fees are expected to increase next year as the City implements certain new fees in an attempt to recover the cost of services provided to Sunnyvale residents. In FY 2003/2004 three new fees were proposed and included in the Fee Schedule. These were the General Plan Maintenance Fee, the Business License Processing Fee, and the False Fire Alarm Fee. All three were implemented during the year and their revenue is included in the Service Fees category. In the recommended FY 2004/2005 Budget two additional new fees are being proposed. These are the Audiovisual Fee for check-out of feature films from the Library and an Emergency/911 Fee to recover the direct costs of the City's Emergency-911 call center. More information on these proposed fees is included in *Volume I* of the recommended FY 2004/2005 Budget in the section on *User Fees*.

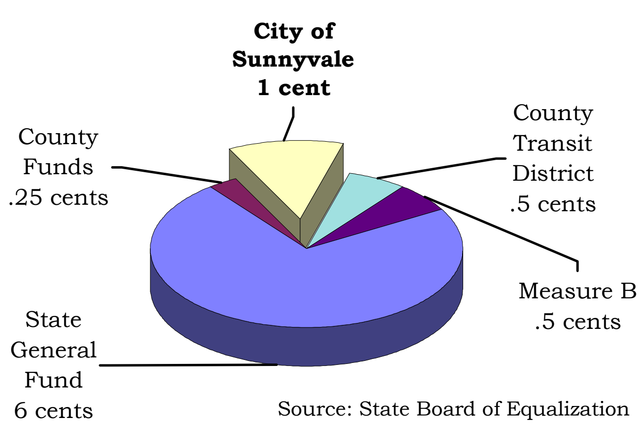
Finally, the large increase in Rents and Concessions is caused by rental revenue collected from the Solid Waste Management Fund for SMaRT Station use of City-owned land. This charge was proposed as part of the FY 2003/2004 Budget and will be received beginning in FY 2004/2005.

Following are detailed discussions of the General Fund's six major revenue categories: Sales and Use Tax, Property Tax, Utility Users Tax/Franchise Fees, Transient Occupancy Tax, construction-related revenues, and State Shared Revenues.

## ***Sales and Use Tax***

Sales and Use Tax represents the second source of revenue to the General Fund. In FY 2000/2001 Sales Tax represented the largest revenue source and constituted 32.4% of total revenue. Since FY 2000/2001 Sales Tax revenue has fallen at a dramatic rate of 41% or nearly $15 million. The graph below shows how Sales Tax dollars are distributed within Santa Clara County. The State receives the largest share of the eight and one quarter cents per dollar of sales, while cities receive only one cent of the rate.

**Sales Tax Distribution**
**8.25 Cents per Dollar - Santa Clara County**



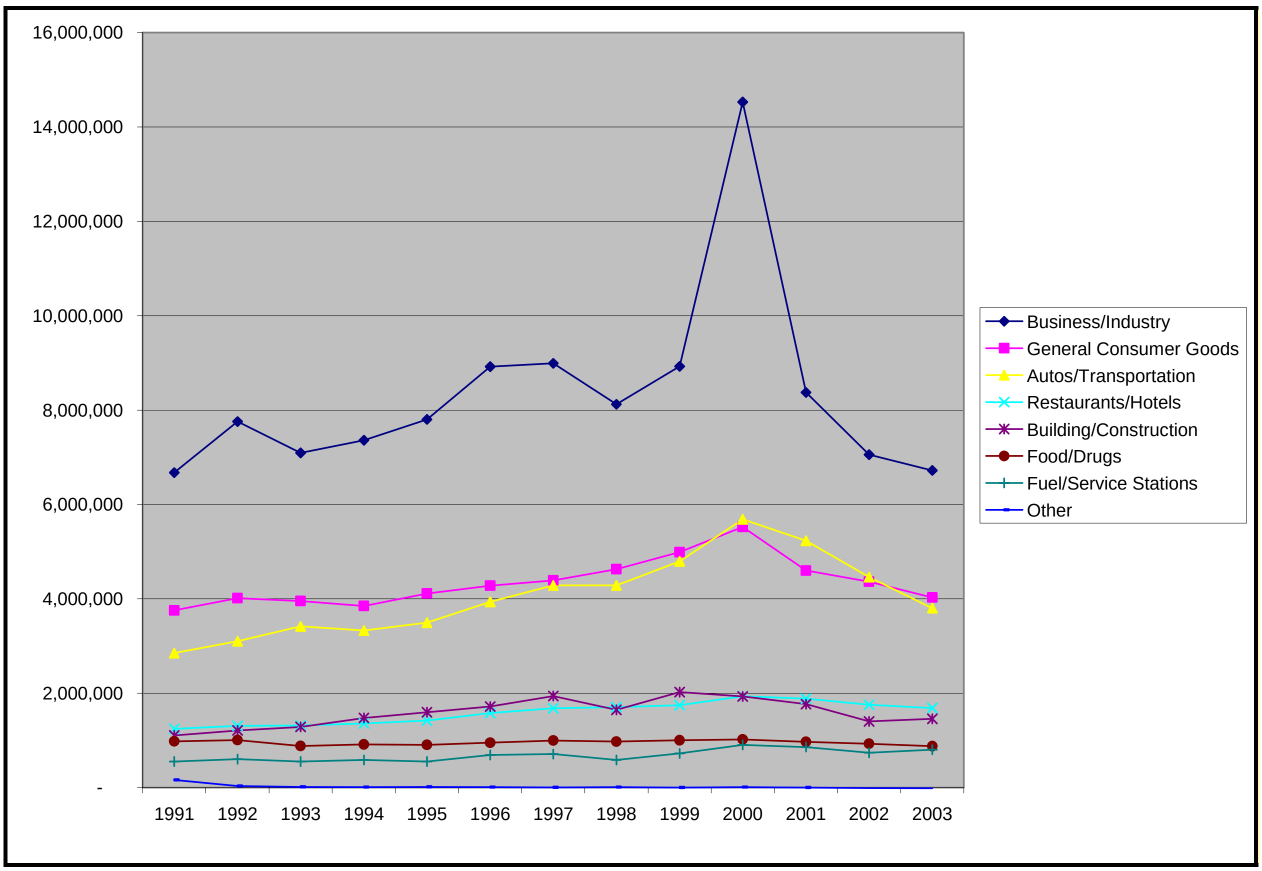
Source: State Board of Equalization

Sales and Use Tax is composed of two different types - general retail sales and business-to-business sales. In Sunnyvale, as well as some other Silicon Valley cities, an unusually high proportion of overall Sales Tax has traditionally been business-to-business in nature. Currently it constitutes nearly 35% of the aggregate.

Our revised Sales Tax estimate for FY 2003/2004, down approximately 6% or nearly $1.5 million compared to our actual receipts for FY 2002/2003, reflects the continuing retrenchment of the local economic base. Based on the most recent receipts for the fourth quarter of calendar 2003, it would appear as though Sales Tax revenues for the Business and Industry sector have bottomed out and are beginning to show slow but measured signs of growth.

Projections for FY 2004/2005 are that the City's Sales Tax revenue will increase by approximately 6%, to $22.7 million. For FY 2005/2006 we are forecasting an increase of 6% to $24.1 million. To develop our projections we divided Sales Tax receipts into four major categories that had similar economic characteristics: Business and Industry, General Consumer Goods, Autos and Transportation, and Other. As can be seen from the graph below, each category has a unique pattern:

**City of Sunnyvale**
**Sales Tax Receipts by Major Sector**
**(Calendar Year 1991 – 2003)**



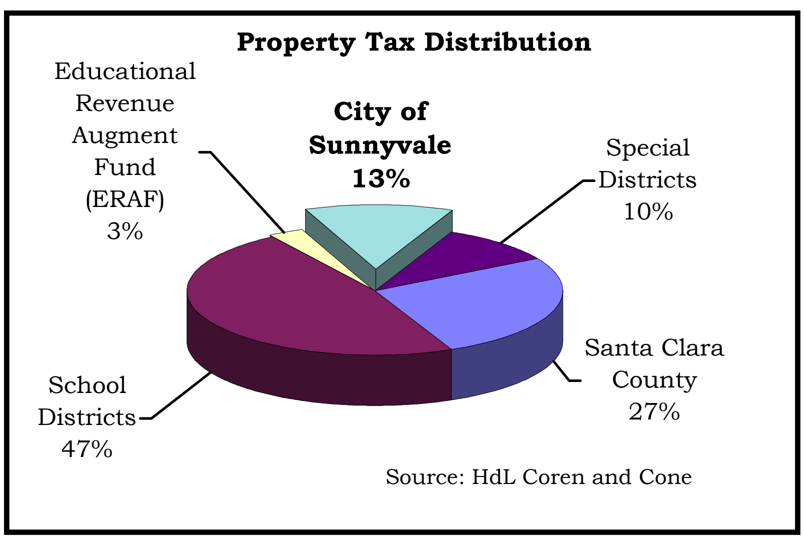
In forecasting our Sales Tax revenues for the next two years and the balance of the financial plan, staff developed individual projections for each sector, and then assimilated the numbers into a single weighted aggregate forecast. Review of the historical data indicated that the Sales Tax had an eight-year economic cycle, which is reflected in our projections over the entire Long Term Financial Plan.

In summary, Sales Tax revenues have experienced wild swings over the last several years. Sunnyvale experienced unprecedented growth of about 20% per year in Sales Tax receipts in FY 1999/2000 and FY 2000/2001 due to a "boom" in high technology business. Unfortunately, this level of revenue was not sustainable. The current economic downturn was already impacting City revenues 3 years ago, as the stock market was undergoing dramatic declines and numerous companies across the nation were implementing cost saving measures that included reducing capital investment. We are now anticipating a mild recovery over the next several years to a more realistic on-going level.

## ***Property Tax***

The Property Tax now represents the largest source of General Fund revenue. Property Tax is up considerably as a percent of General Fund revenues compared to the prior year as a result of sharply declining receipts from Sales Tax and will surpass Sales Tax revenue by year-end.

The following graph shows how Property Tax dollars are distributed in Santa Clara County. Sunnyvale currently receives 13% of every Property Tax dollar paid by property owners in the City. If the State budget deal is approved, the percent of Property Tax received by the City will increase.




Property Tax has also been the revenue most affected by voter initiatives and legislative actions. With approval of Proposition 13 more than 20 years ago, Property Tax revenues were reduced by two-thirds and thereafter limited to 2% annual increases or the CPI, whichever is less. In the early 1990s, the State legislature shifted a larger portion of the Property Tax to schools. This shift was made to the State's Educational Revenue Augmentation Fund ("ERAF") to backfill a portion of the State's obligation for school funding. As shown in the graph, this "ERAF shift" is now 3% of the Property Tax dollar, representing an annual loss to the City of Sunnyvale currently amounting to approximately $6.3 million.

Even with the recent declines in the commercial real estate market, our Property Tax revenues have grown. This is due to two major factors. First, Property Tax typically lags economic conditions by a year or more because of the assessment schedule and the time it takes to get a property transactions onto the rolls. Previous increases in real estate values are now being reflected on the assessment rolls. The second factor is the relative strength of the residential property segment. These two factors will result in a projected 1% increase overall in Property Tax revenue in FY 2003/2004 compared to the amount received in FY 2002/2003.

Revenue from Secured Property Tax, which represents about 80% of total Property Tax revenues, is projected to increase by approximately 3% next year. While the residential market appears to be holding its own, there are significant declines in the value of commercial property due to the area's high vacancy rates. However, the Santa Clara County Assessor has proactively reduced assessed valuations Countywide for both residential and commercial parcels and we expect this action to mitigate the effect of assessment appeals on our revenues.

In developing future projections we developed a model similar to that used for our Sales Tax forecasts. For Secured Property Tax we isolated the assessed valuations for both Residential and Commercial/Industrial, as each segment represents different stages of the economic cycle. For FY 2004/2005 we have anticipated continued growth in residential valuations since the residential housing market remains strong. Assessed valuations associated with commercial and industrial properties are anticipated to remain flat for the next fiscal year as this sector continues to have high vacancy levels. In the following fiscal year, FY 2005/2006, we anticipated 6% growth in the residential sector and 0.5% for commercial and industrial properties. We then used the eight-year economic cycle to project revenues for the remainder of the financial plan. Projections are that residential property tax will remain strong for the first ten years of the planning period, while the commercial sector will stay flat until FY 2007/2008 when it increases by an average of 3.5% through FY 2013/2014.

The proposed State budget deal has been reflected in our Property Tax projections beginning in FY 2004/2005. As discussed earlier, the Property Tax base will increase next year in relationship to a reduction in Vehicle License Fee revenues. This increase will be permanent, and the new base will grow in the following years with the actual growth of Property Tax.

## ***Utility Users Tax and Franchise Fees***

Utility Users Tax (UUT) and Franchise Fees combined represent the third largest source of General Fund revenue. Historically, these two revenue categories have been combined because one of the primary sources of revenue for both is sale of electricity and gas.

As indicated in Table II, receipts from UUT are expected to decrease by nearly 2% in FY 2003/2004 compared to last year's receipts. This decline is primarily driven by a decrease in electrical rates charged by Pacific Gas & Electric ("PG&E"). In February of this year PG&E announced that the California Public Utilities Commission ("CPUC") had approved an average rate decrease of approximately 8% effective as of March billing statements. This electric rate decrease is projected to be somewhat offset by increases in usage due to improved commercial building occupancy and higher natural gas prices. UUT and Franchise Fee revenues are projected to increase by 3% from FY 2004/2005 through FY 2013/2014, and 4% for the second ten years of the Long Term Financial Plan.

### ***State-Shared Revenue***

State-shared revenues represent the General Fund's fourth largest revenue source. Vehicle License Fees ("VLF") currently make up over 91% of State-Shared Revenues. VLF is an annual fee on the ownership of a registered vehicle in California, levied in place of a property tax on vehicles. These fees are collected by the State and distributed to local jurisdictions on a per-capita basis. Total revenues are allocated 61% to the State, 27% to counties, and 12% to cities. The local portion of the VLF is constitutionally protected as to allocation formula.

The State's adopted FY 2003/2004 Budget included a reduction in VLF fees to local governments. Based upon last year's receipts staff estimated this would result in a reduction in City revenue of approximately $1.8 million for the current year. The revised FY 2003/2004 estimate for VLF is $5.7 million.

The recommended FY 2003/2004 Budget reflects the provisions of the State budget deal which permanently reduces the VLF rate and corresponding revenues to local government. This reduction equals 67.5% of the total. Our projections beginning in FY 2004/2005 show only the remaining base amount of the VLF and are therefore substantially lower than prior years.

Growth in this revenue in prior years had been driven by extremely strong auto sales resulting from the robust economy. However, even as the economy faltered, statewide vehicle sales remained surprisingly strong, in part due to unusually generous financing offers. For the reminder of the financial plan we have based our VLF projection on the historical receipts associated with the Autos and Transportation segment of the City's Sales Tax revenue. We are projecting a 6% annual increase for the first ten years of the Long Term Financial Plan and 4.4% for the second ten years.

The projected FY 2004/2005 reduction in State Shared revenue as compared to FY 2002/2003 actuals also reflects the cancellation of booking fee reimbursements as part of the State budget for FY 2003/2004. The proposed State Budget for FY 2004/2005 does not contain booking fee subventions going forward. There is some discussion occurring at the State level about booking fees, but it is likely to result in reduced costs rather than reinstating these revenues.

### ***Transient Occupancy Tax***

Transient Occupancy Tax ("TOT") represents the fifth largest revenues source of the General Fund. In prior years, TOT has been the third largest source and constituted about 10% of the total.

The year 2000 was a banner year in the hotel industry, and especially so for Silicon Valley hotels. During the boom of FY 1999/2000 and FY 2000/2001, the City's TOT revenue enjoyed significant growth. Beginning in approximately 1995, improved economic conditions led to higher occupancy rates and room charges, as well as the addition of several new hotel and motel properties. Our TOT rate was also increased from 8% to 8.5% in 1995. However, this revenue is particularly susceptible to economic cycles because both occupancy rates and room rates are closely linked to economic conditions. The bulk of our TOT revenue stems from weekday business travel, as evidenced by an extremely high level of correlation between TOT revenue and Sales Tax revenue from the Business and Industry category.

Over the past two years, Sunnyvale hotels have seen significant reductions in both average occupancy rate and average room rate. These decreases are directly related to the drastic downturn in the local economy and the current state of uncertainty surrounding the global economy.

As a result of these economic factors, we have seen a dramatic drop in our TOT revenues this year, which we forecast will be approximately 11% lower than last year's receipts. Compared to FY 2000/2001, this translates to a reduction of more than 57% or over $6 million.

Based upon the most recent level of receipts, we are anticipating that TOT revenues have effectively bottomed out and are starting to show slow but measured indications of growth. Due to this recent trend, and to the extremely high correlation of TOT to Business and Industry Sales Tax, our projections for TOT mirror those associated with the Business and Industry Sales Tax category for the remainder of the Long Term Financial Plan. Our estimates for FY 2004/2005 show an increase of 10% to approximately $5 million, and for FY 2005/2006 increase by 10% to approximately $5.5 million. Future year projections mirror the business cycle seen in the Business and Industry Sales Tax sector and average approximately 6% over the remainder of the planning period.

***Construction-Related Revenue***

Construction-related revenues represent about 5% of General Fund revenues in the current year. This category includes Construction Tax as well as receipts from the issuance of building, electrical and other permits. Plan Check Fees are also reflected here. Due to a number of large commercial projects, as well as general increases in construction, these revenues showed extraordinarily large gains in FY 1999/2000 and FY 2000/2001. Clearly the economic downturn caused the levels of construction-related revenue to trend downward significantly in FY 2001/2002 and FY 2002/2003. Unusually high levels of residential development currently have caused the original projection for FY 2003/2004 to increase by approximately 17%. We have based future years' projections on an historical eight-year economic cycle. The forecast for FY 2004/2005 calls for growth of approximately 5.8% and 10% for FY 2005/2006. In the following years construction-related revenue will grow at lower levels from FY 2006/2007 until FY 2007/2008, and then decline until FY 2011/2012. The business cycle will then be repeated over the remainder of the planning period.

### *General Fund Expenditures*

Table III outlines the recommended expenditures for the General Fund and Gas Tax Fund combined. Although these are separate funds, they are added together in Table III to better represent the proposed changes from one year to the next. It is in the interest of the City to expend Gas Tax Funds for eligible projects and operating activities before utilizing General Fund money. This results in increases and decreases from year to year regarding the amount of road maintenance operations that are funded by the Gas Tax Fund and General Fund respectively. By combining the two funds, a clearer picture results as to the year-to-year changes.

As Table III below indicates, the overall combined recommended expenditures of the General Fund and Gas Tax Fund for FY 2004/2005 are 2.01% above the Revised FY 2003/2004 Budget. However, because certain aspects of the budget can change dramatically from year to year, notably capital, infrastructure and special projects, a more precise understanding of the comparative budget is in the operating area.

***Table III Recommended Expenditures – General Fund and Gas Tax Fund Combined***

| Expenditure Character | 2002/2003 Actual | 2003/2004 Revised Budget | 2004/2005 Proposed Budget | % Growth 2004/2005 over 2003/2004 | 2005/2006 Proposed Budget | % Growth 2005/2006 over 2004/2005 |
|---|---|---|---|---|---|---|
| Operating | 89,839,851 | 92,965,044 | 101,527,119 | 9.21% | 107,715,735 | 6.10% |
| Budget Supplements* | 0 | 0 | 51,290 | N/A | 52,316 | 2.00% |
| Project Operating | 0 | 0 | 0 | N/A | 43,103 | N/A |
| Projects | 5,902,315 | 6,864,082 | 1,699,943 | (75.23%) | 2,289,230 | 34.67% |
| Debt | 410,778 | 411,468 | 411,358 | (0.03%) | 410,138 | (0.30%) |
| Lease Payments | 1,215,678 | 1,216,678 | 1,211,728 | (0.41%) | 1,210,558 | (0.10%) |
| Equipment | 0 | 300,000 | 0 | N/A | 0 | N/A |
| Fiscal Strategies | 0 | 0 | (1,100,000) | N/A | (2,300,000) | 109.09% |
| **TOTAL** | **97,368,622** | **101,757,272** | **103,801,438** | **2.01%** | **109,421,080** | **5.41%** |

* In FY 2002/2003, Recommended budget supplements totaled $4,129,424. Upon Council approval these costs are included in the Operating and Projects character lines.

The operating portion of the recommended FY 2004/2005 Budget is 9.21% above the Revised FY 2003/2004 Budget. However, this increase is primarily attributable to a major increase in CalPERS retirement costs, which are not under the City's control. The operating total reflected in the above table includes approximately $5.42 million in increased retirement costs for FY 2004/2005 above the current level. <u>When these retirement increases are factored out of the calculation, the real increase in General Fund operations is 3.4%.</u>

The recommended FY 2004/2005 Budget is built on several key salary and benefit assumptions. First, salary increases have been projected based on preliminary survey information from the Human Resources Department. The following table indicates assumptions for salary increases in the future:

| Labor Unit | FY 2004/05 | FY 2005/06 | FY 2006/07 – FY 2013/14 | FY 2014/15 – FY 2023/24 |
|---|---|---|---|---|
| SEA/Confidential | 2.10% | 3.00% | 3.00% | 4.00% |
| PSOA | 3.40% | 4.10% | 3.00% | 4.00% |
| COA | 3.40% | 4.10% | 3.00% | 4.00% |
| SEIU | 8.12% | 3.00% | 3.00% | 4.00% |
| Management | 2.10% | 3.00% | 3.00% | 4.00% |

*Increase for SEIU in FY 2004/05 represents an average increase for all classifications.

In general, all employees saw significant salary increases as the result of our local labor market and the City's competitive compensation philosophy during the past several years. Our labor agreements for all of the four bargaining units are still in effect, with SEA expiring on June 30, 2004. As Council knows, these agreements contain formulas that determine what salary increases will be in the future. These formulas are based on market comparisons with predetermined comparable cities within our labor market. We are not aware that a significant number of our comparator cities have asked for or received wage concessions from their employees this year. However, as shown in the above table, we are assuming that economic conditions will moderate future salary increases in our comparator cities.

An equally disturbing trend, with significant fiscal implications for the future, is the rapid escalation being experienced in the cost of personnel benefits. The recommended FY 2004/2005 Budget contains an increase of 21% in expenditures for the Employee Benefits Fund over this current year, and 9% for FY 2005/2006. The largest component of these increases by far is the cost of retirement contributions, which are continuing to rise as the effect of prior years' PERS investment losses are reflected in the new contribution rates. Detailed discussions of each of these costs are included in the *Detailed Fund Reviews* section of this Transmittal Letter under *Employee Benefits and Insurance Fund*.

Several other changes to General Fund expenditures are noteworthy. First, the Economic Prosperity programs of the Community Development Department that are <u>not</u> directly related to the Redevelopment Agency have been moved from the Redevelopment Agency Fund to the General Fund. This results in an increase in operations of about $515,000 but also allows a larger repayment by the RDA Fund for the outstanding General Fund loans.

Second, funding for municipal election costs have been restored throughout the entire plan. Last year a Study Issue was proposed to explore the feasibility of consolidating municipal elections with State and Federal elections in even-number years in order to reduce election costs. Following the Study Issue, Council concluded that the City would be better served to keep the General Municipal Election in the odd-numbered years. In keeping with this policy direction, funds of about $60,000 additional for the separate elections have been included in the Office of the City Manager budget every other year.

Another change is the inclusion of the two separate Special Projects managed by the Office of the City Manager into a new program in their operating budget. In previous years, the Youth and Family Services project and the Integrated Neighborhood Services project reflected in the *Project Operating Costs* line of the General Fund *Expenditure* section. These costs are now included in operations in the approximate amount of $335,000, and the *Project Operating Costs* have been reduced accordingly. There is therefore no net fiscal impact to this change.

Finally, the recommended FY 2004/2005 Budget includes approximately $1.1 million in additional appropriations for the Department of Public Safety as follows:

- Salary increases for the Public Safety Officers Association (PSOA) and the Communications Officer Association (COA) were approved by Council in December 2003 on a one-time basis. On an annualized basis this direction has added $576,001 to the department's budget.

- Per Council direction staff has added two positions (1 Public Safety Officer II and 1 Public Safety Lieutenant) to Program 485 – Special Operations Vice and Narcotics activities. Through this addition the ratio between proactive and reactive investigation has been raised to 60% and 40% respectively. This change in service level represents an addition of $373,366.

- Staff has increased hours in order to fully fund 1 Internal Affairs Investigator. This position had previously been funded via SLES/BJA grant revenue. Due to continual declines in grant awards from both agencies staff has recommended to fully fund this position through the General Fund. The increase in budgeted hours represents a $98,344 increase in obligations to the General Fund.

- Staff has added 1 Hazardous Materials Inspector to the FY 2004/2005 budget per Council direction received on March 30, 2004. Funding for this position will be partially offset by anticipated grant revenues for the California Integrated Waste Management Board. The remaining funding requirement will be derived from increases in fees and charges associated with City's Hazardous Materials program. Staff anticipates that this reduction will add only nominal costs to the General Fund.

Table IV, on the following page, outlines the recommended expenditures for the General Fund only. Looking at just the General Fund, the proposed operating expenditures for FY 2004/2005 are 9.41% above the Revised FY 2003/2004 Budget. Total General Fund recommended expenditures, including projects, debt, and equipment, are 3.07% above the Revised FY 2003/2004 Budget.

| Table IV Recommended Expenditures – General Fund | | | | | | |
|---|---|---|---|---|---|---|
| Expenditure Character | 2002/2003 Actual | 2003/2004 Revised Budget | 2004/2005 Proposed Budget | % Growth 2004/2005 over 2003/2004 | 2005/2006 Proposed Budget | % Growth 2005/2006 over 2004/2005 |
| Operating | 89,006,156 | 90,965,044 | 99,527,119 | 9.41% | 105,715,735 | 6.22% |
| Budget Supplements* | 0 | 0 | 51,290 | N/A | 52,316 | 2.00% |
| Project Operating | 0 | 0 | 0 | N/A | 43,103 | N/A |
| Projects | 4,456,134 | 5,377,990 | 1,186,220 | (77.94%) | 1,519,118 | 28.06% |
| Debt | 410,778 | 411,468 | 411,358 | (0.03%) | 410,138 | (0.30%) |
| Lease Payments | 1,215,678 | 1,216,678 | 1,211,728 | (0.41%) | 1,210,558 | (0.10%) |
| Equipment | 0 | 300,000 | 0 | N/A | 0 | N/A |
| Fiscal Strategies | 0 | 0 | (1,100,000) | N/A | (2,300,000) | 109.09% |
| **TOTAL** | **95,088,746** | **98,271,180** | **101,287,715** | **3.07%** | **106,650,968** | **5.30%** |

* In FY 2002/2003, Recommended budget supplements totaled $4,129,424. Upon Council approval these costs are included in the Operating and Projects character lines.

### *Budget Supplements*

Budget supplements are called out separately in the recommended budget to draw a distinction between the service levels provided in the baseline budget and recommended expansion or reduction of service levels. Supplements are normally presented to the City Manager by staff during the budget review process and then the City Manager makes a recommendation to Council. If a supplement is approved as part of the budget adoption in June, that particular activity is moved into the baseline budget and reflected as such in the adopted budget document.

This year, there are four budget supplements included in *Volume I* of the budget document. Three of these were initiated by staff, and the fourth reflects the results of the Council service reviews conducted in March and April.

- **Budget Supplement #1 – Continue Additional Funding for Sunnyvale Library's Children Collection:** During the last operating budget cycle, analysis indicated that the materials acquisition budget was inadequate for the demands on the children's collection. $40,000 was added for each year of the two-year budget, to be reviewed during the following budget process. Current circulation data indicate demand has continued to grow for children's materials and this budget supplement seeks to continue the funding on an on-going basis. The City Manager is recommending that this supplement be funded by Public Library Funds rather than the General Fund.

- **Budget Supplement #2 – Reallocate Resources from Employee Communication to Website Content Management:** To assume content responsibilities for the City's website, the Communications Division in the Office of the City Manager is requesting reallocation of resources within the division to take on these responsibilities. No additional funding is requested. However, the reallocation will reduce the publication of the Harbinger (Sunnyvale's electronic employee newsletter) from 12 to 6 times a year, shift scheduling and management responsibilities of the Utility Bill Insert program to the Finance Department and reduce time spent on the design for KSUN-18 slides.

- **Budget Supplement #3 - Recommendations of Council Service Review Process:** The services that Council provided policy direction on have been reviewed by the City Manager. Costs for these services and the City Manager's recommendations are included. The Budget Supplement includes detailed information regarding the amount of reduction or increase and the service level effect for each service.

- **Budget Supplement #4 – Funding for the 2004 Downtown Summer Music Series:** The Sunnyvale Downtown Association has requested support from the City for the Downtown Summer Music Series "Music and Market." This budget supplement would provide up to $4,500 to help defray the costs of Public Safety and Public Works services provided for this series. These one-time costs would be budgeted into a special project in the General Fund if approved.

Detailed reports for these budget supplements are located in *Volume I* of the recommended budget document, under *Budget Supplements*.

***General Fund Projects***

This is the second year of the two-year budgeting cycle for projects. Therefore, staff efforts were limited to review of newly proposed projects and those that had changed significantly in scope or cost. By and large, the General Fund projects contained in last year's Ten-Year Resource Allocation Plan have experienced few changes in timing, cost, or scope. This Transmittal Letter focuses on newly developed or significantly revised projects. Descriptions and detailed financial information on all projects can be found in the budget document, *Volume II, Projects Budget*. There are two helpful indexes of all the City's projects, one alphabetically oriented (by project name) and the other numerically oriented (by project number).

The recommended FY 2004/2005 Budget for the General Fund includes $142,893 in Capital Projects, $764,721 in Special Projects, and $142,531 in Outside Group Funding Projects. Additionally, as mentioned earlier in this Transmittal Letter under *Major Project Efforts*, General Fund-related projects are found in several places in the budget. They are in the General Fund, the Gas Tax Fund, the Capital Projects Fund, and the Infrastructure Renovation and Replacement Fund. In general, these categories are considered to be related to the General Fund because it is the ultimate source of financial support through contributions or transfers. For example, the General Fund is scheduled to make annual contributions to fund its infrastructure projects in the Infrastructure Renovation and Replacement Fund and to fund its capital projects in the Capital Projects Fund.

Several major capital or special projects have been discussed earlier in this Transmittal Letter in the *Major Project Efforts* section. The following are additional projects affecting the General Fund which are either new or have changes in funding in the recommended FY 2004/2005 Budget:

- **Property and Evidence Purge Project** - According to a "Needs Assessment" done for the Public Safety Property Unit, there is a significant backlog of case evidence that needs to be purged. There are currently 6,522 cases eligible for purge; these are cases for which conviction and sentencing data is available, the statute of limitations has passed, no arrests have occurred, and/or the property is listed as found or safekeeping. This project is necessary to accommodate serious space needs within Public Safety's existing Property/Evidence facility and to ensure we are maintaining compliance with legal mandates as well as industry standards set by IAPE (International Association of Property and Evidence Professionals). The project has been programmed in the General Fund in the amount of $31,512 for FY 2004/2005, $32,142 in FY 2005/06 and $32,785 in FY 2005/06.

- **Murphy Avenue Decorative Street Lighting Replacement:** Every two years, the decorative tree lights on Murphy St. need to be removed and replaced, and the trees need to be pruned by the tree crew. Without this maintenance effort, the trees become overgrown and the lights break down resulting in an unsightly downtown appearance. This project was originally budgeted in FY 2003/2004 in the General Fund Assets Sub-fund of the Infrastructure Fund. Starting in FY 2004/05, this project has been programmed as a placeholder. Funds will not be appropriated until a Business Improvement District in the Downtown Area has been established to provide ongoing funding for these costs.

- **Bernardo Avenue CalTrain Undercrossing:** This project provides for the construction of a bicycle and pedestrian undercrossing of the CalTrain tracks at Bernardo Avenue. The total cost of this project has been estimated at $1.3 million, with 80% to come from the Santa Clara Valley Transportation Authority ("VTA") as part of their bicycle expenditure program, and the 20% match to come from the City's Gas Tax funds. The VTA's contribution is scheduled to be allocated September 2004.

In addition to the direct funding of capital and special projects discussed above, the General Fund makes an annual contribution to the Infrastructure Renovation and Replacement Fund to support the Long Range Infrastructure Plan. The recommended FY 2004/2005 Budget and Long Term Financial Plan includes an ongoing contribution of approximately $2.2 million for FY 2004/2005, increasing with inflation over the twenty-year planning period. *Volume II, Projects Budget* contains details on the Infrastructure projects included in the recommended FY 2004/2005 Budget.

### *General Fund Reserves and Set-Asides*

One of the most powerful aspects of multi-year financial planning is its capability to recognize trends over time and begin at an early point to consider the necessary steps to alter the long-term forecasted position of a particular fund should that appear necessary. The reserves and set-asides contained in the General Fund's Long-Term Financial Plan play a pivotal role in the City's multi-year planning strategy.

The City has established five reserves in the General Fund that are restricted by prior policy or legal requirements to specific uses. Most of the City's reserves are established in accordance with policy adopted in the Fiscal Sub-Element of the General Plan. Policy 7.1B.8: states:

> "Reserves: Provide a prudent level of reserves for future unexpected expenses and revenue declines; to accumulate funds to support future planned capital improvements, and to level high and low expenditure years in the Ten-Year Resource Allocation Plan."

The General Fund currently has four reserves that are designed to be used according to the policy above. These reserves are contained in the General Fund's financial plan under the sub-heading, *Designated Reserves*.

The first is the *Contingencies Reserve* equal to 20% of the operating budget each year. This reserve is to be used only in case of emergency or disaster, and is not intended for normal unanticipated expenditures. In the Fiscal Sub-Element, the policy calls for this reserve to be 10% of operations, but Council policy in FY 1992/1993 changed it to 20% of operations. This reserve changes each year as operations of the General Fund either increase or decrease.

The General Fund also has an additional 5% of operating costs in the *Service Level Contingency Reserve.* This reserve was established in FY 1993/1994 to provide funds for increased service levels or costs in excess of inflation. In earlier years, the Resource Allocation Plan contained an on-going set-aside called the "One Percent of Operations Set-aside" that provided the ability to handle revenues that did not perform as well as projected and expenditures that increased more than inflation. This set-aside was replaced by the *Service Level Contingency Reserve*. It is important to note that the reserve is one-time, and once drawn down it is gone. The set-aside, on the other hand, was available each year and accumulated if not used.

A third reserve in the General Fund is the *Non-Recurring Events Reserve.* This reserve contains funds from FY 1997/1998 and FY 1998/1999 that resulted from greater than anticipated revenues and lesser than anticipated expenditures as this extraordinary economic cycle saw continued growth. By Council action, these types of one-time funds resulting from the peak of the economic cycle were set aside for significant high-priority capital and special projects and not used to add recurring services. In prior years, these funds were programmed over a several year period for the following major projects:

- Senior Center Construction,
- Animal Field and Shelter Facility Construction, and
- Fremont Pool Construction.

An additional $1.5 million was added to the *Non-Recurring Events Reserve* in the adopted FY 2001/2002 Budget to be spent as necessary on important one-time projects. This reserve has been reduced dramatically as the City has paid for the Senior Center Construction project. The balance of this reserve at the end of FY 2003/2004 is currently projected to be $490,212.

A fourth reserve in the General Fund is entitled the *20-Year RAP Reserve.* This reserve functions to levelize economic cycles from year to year. By letting this reserve vary each year, the fund can absorb the cyclical effects of the economy and specifically plan for project-related expenditures. In essence, this reserve grows during periods of economic growth and is drawn down during the low points of economic cycles to maintain stable service levels. The *20 Year RAP Reserve* functions very effectively to prevent us from adding services at the top of the economic cycle that cannot be sustained while allowing us to maintain Council-approved services levels during economic downturns. This is in sharp contrast to jurisdictions like the State of California, which greatly increased spending during the boom and is now faced with making draconian expenditure reductions in the face of revenue shortfalls.

The function of the *20-Year RAP Reserve* and its strength has been particularly apparent in the last two years as the City has struggled with the rapid economic downturn in the region. In prior years when the City was experiencing strong economic growth, the reserve was building up over time to the $61 million level reached in FY 2002/2003. Then, as the effects of the economic downturn began to be fully felt, the reserve was available to provide a “cushion” to maintain City services at desired levels. In the recommended FY 2003/2004 Budget a structural imbalance between revenues and expenditures of $14-15 million was identified, and a plan consisting of a combination of service level/expenditure reductions and fee increases was implemented to bring the General Fund into balance over the twenty-year planning period. Last year's Long-Term Financial Plan showed the *20-Year RAP Reserve* being drawn down even with the proposed budget reductions until FY 2013/2014, when we projected that the economy would stabilize and begin to grow.

A detailed discussion of our current projections for the 20-Year RAP beginning in FY 2004/2005 is found in the section below entitled *General Fund Fiscal Position.*

Finally, the City has one restricted reserve, the *Land Acquisition Reserve,* which has a balance of $3 million. This reserve was established in FY 1994/1995 for the purpose of purchasing land or property in the downtown area with an emphasis on future income generation through economic development. It has been used to purchase key parcels in the downtown area, and as the land is sold to the private sector, the reserve is replenished.

During FY 2004/2005 staff will be reviewing the use of reserves and their appropriate levels as part of our fiscal strategies.

### *General Fund Financial Position and Required Fiscal Strategies*

The further decline in Sunnyvale’s General Fund revenues and another sharp rise in personnel costs have led to a continuing structural imbalance between revenues and expenditures in the City’s General Fund. Last fiscal year the structural gap was estimated to be $14-15 million, but as noted above a combination of service level/expenditure reductions and fee increases was adopted to address this problem. In spite of these actions we are projecting that revenues and expenditures will still be out of balance for the first portion of our planning period.

For the FY 2004/2005 Long Term Financial Plan, a new section has been added to the bottom underneath the *Fund Balance* information to display the *Total Current Resources*, *Total Current Requirements*, and the *Difference* between them. As can be seen from this information, a structural imbalance between revenues and expenditures exists for the first five years of the plan, or through FY 2008/2009. In FY 2009/2010 the revenues and expenditures are essentially even and then revenues begin to be greater than expenditures by varying amounts.

The recommended FY 2004/2005 Budget and Long Term Financial Plan for the General Fund includes several elements that contribute both positively and negatively to the fiscal status. All known provisions of the Governor's proposed State Budget have been reflected, as described above in the section on *Effects of State Budget Deal on Estimated Revenues.* The effects of the Triple Flip required by the State's Economic Recovery Bonds have been portrayed over a ten-year period.

Two local actions that may have an extremely positive impact on the fiscal condition of the General Fund have been anticipated in the FY 2004/2005 Plan. First, full implementation of the Emergency/911 fee that was proposed last year has been reflected. The FY 2003/2004 Adopted Budget included revenues of $250,000 annually from this source beginning in FY 2004/2005. Further refinement of our methodology has led staff to conclude that the original projections were substantially understated, and so we have included an additional $1,750,000 in revenues from this source beginning in FY 2004/2005.

Second, the additional Sales Tax that will be generated from redevelopment of the Town Center Mall has been reflected in the plan starting in the second half of FY 2007/2008. This revenue has been estimated net of potential additional City costs that may be required by the development.

When all of the elements discussed above have been taken into consideration, the General Fund Long Term Financial Plan <u>will still require decreases in expenditures or increases in revenues in order to balance</u> over the first portion of the planning period. Staff is reflecting the amount of these actions needed in the line item *Fiscal Strategies* contained in the *Expenditures* section of the plan. As can be seen, strategies that will either reduce costs or increase revenues will need to be in place starting midway through FY 2004/2005 and will continue through FY 2011/2012.

Staff is recommending that Council make its final decision on the service level reductions in December 2004. This will allow for a comprehensive analysis of each reductions and the development of an implementation plan. Additionally, several currently unknown factors will be resolved. First, it is likely that the State budget will have been passed and its ramifications fully understood. Second, the fate of the LOCAL initiative to be voted on in the November 2004 election will be decided and its effect on our long-term revenues will be clearer. Third, the state of the local economic recovery will be more apparent after several quarters of experience. Finally, staff will have time to explore a number of the cost saving strategies and ideas included in

Appendix A. Some of these strategies may produce cost savings or revenue increases which would mitigate the need for the identified service level reductions. At that point, Council would need to prioritize the recommended reductions along with the proposed cost saving strategies. Staff will seek Council direction as to the reductions and other fiscal strategies in December 2004.

### ***Fiscal Uncertainties***

In past years the General Plan Long Term Financial Plan has contained a planned expenditure called *Fiscal Uncertainties.* The *Fiscal Uncertainties* line item is contained within the *Expenditures* section of the financial plan, and it represents the on-going latitude that is available to increase service levels, add new annual programs, or address unexpected fiscal pressures. This number is normally derived from the last year of the 20-year plan. It is essentially determined by setting the *20-Year RAP Reserve* at zero for the 20th year but maintaining the required contingency reserve. If a positive number appears in the *Fiscal Uncertainties* line in year one, this reflects the remaining latitude the City has to deal with any issues or assumptions not included in this recommended financial plan. If this number turns negative, then it reflects the amount of budget reduction and/or revenue increase that is needed at the beginning of the planning period in order to avoid the long-term plan effectively going into true deficit.

For the last two years, it has been clear that budget reductions and revenue increases were going to be necessary in order to balance the structural deficit in the General Fund. In the Adopted FY 2003/2004 Budget the *Fiscal Uncertainties* line item was retained as a small amount that could be available to Council for unexpected operating costs.

For the recommended FY 2004/2005 Budget the *Fiscal Uncertainties* line item has been zeroed out for the first nine years of the plan. However, assuming that the strategies discussed above are put into place and the Long Term Financial Plan is balanced, as revenues begin to exceed expenditures in the latter part of the first ten years it will be possible to reinstate the *Fiscal Uncertainties* line item beginning in FY 2013/2014. At this point, approximately $1.2 million will be available on an ongoing basis to provide latitude for increased service levels or financial issues that we may be experiencing. <u>It should be cautioned, however, that there are a number of pressures on the expenditure side that may pose fiscal challenges for the City in the upcoming years.</u> These include items on the expenditure side that are growing faster than inflation, such as personnel costs and benefits, and items that may jeopardize our ability to collect City revenues. Examples of this latter category include the changes in telecommunications such as Voice Over Internet Protocol (VOIP) that may reduce our Utility Users Tax in the future. An additional challenge will be the unfunded capital and infrastructure projects that have been identified this year which total about $200 million.

Of course, the fiscal issues and challenges that we face do not impact only the City of Sunnyvale, and our long-term approach to financial planning puts us in a far better position to address them. Still, caution is advised and Council is urged to stay the course in "changing our lifestyle" to accommodate our reduced revenue base.

## Gas Tax Fund

The Gas Tax Fund is required by State law to account for gas taxes collected and allocated by the State. These taxes are levied on gasoline and other motor fuels in terms of cents per gallon, and these funds are then distributed to the State, cities and counties on a formula based on population. Revenue forecasts for this fund utilized year-to-date projected receipts increased by the Association of Bay Area Governments (ABAG) estimated population growth rate for Sunnyvale.

Beginning in FY 2001/2002 new state funding for streets and road systems (AB 2928 - State Traffic Congestion Relief Program) has been held and accounted for in the Gas Tax Fund as required by state law. A complete discussion of this revenue source and the projects associated with it can be found in the *Major Project Efforts* section of this Transmittal Letter.

Gas Tax funds are spent on maintenance and capital related to public streets and highways. As noted in the previous discussion of the General Fund, the Gas Tax Fund works in tandem with the General Fund. Essentially, a level of Gas Tax funding for operations is established, with remaining funds used to cover Gas Tax-eligible capital projects.

Operating expenses programmed for street maintenance in this fund are $2 million for FY 2004/2005 through FY 2006/2007. In future years, operating expenses vary from $2 million to $2.7 million each year.

The recommended FY 2004/2005 Budget for the Gas Tax Fund has 2 capital projects totaling $24,753. These are for Roadway Geometric Improvements ($14,653) and Transportation Project Design ($10,100).

The project administration expenditure in the Gas Tax Fund represents the in-lieu charge for Engineering Services that are expected to be utilized in supporting Gas Tax-funded capital projects; these projects are reflected here and also in the Capital Projects Fund. The cost is higher over the first three years of the long-term financial plan because there are a number of large-scale projects that are programmed from Gas Tax revenues during that time period.

Finally, the recommended FY 2004/2005 Budget reflects a transfer to the Capital Projects Fund/Gas Tax Sub-fund of $3,197,352 to support street-related capital projects as follows:

| | |
|---|---|
| Washington and Mathilda Intersection Improvements | $802,000 |
| Mathilda Avenue Railroad Overpass Improvements | 2,395,352 |

## ENTERPRISE FUNDS

The Enterprise Funds of the City incorporate programs and activities that are either fully self-supporting by way of user charges and fees or partially self-supporting. Those that are partially self-supporting require some level of transfer from the City's General Fund.

The City has three utilities that are fully self-supporting, including the Water Supply and Distribution Fund, Solid Waste Management Fund, and Wastewater Management Fund. Additionally, the SMaRT Station® Fund has been established to account for operations at the Sunnyvale Materials Recovery and Transfer Station, which is a partnership among the three cities of Sunnyvale, Mountain View and Palo Alto. This fund consists of two sub-funds, one used to account for SMaRT Station operations and the other used to account for equipment replacement needs.

In April 2004 Council approved the following rate changes as recommended by staff:

| Utility | Rate Change |
|---|---|
| Wastewater | 5.0% |
| Water | 5.0% |
| Solid Waste | 4.0% |

Each rate increase and the factors contributing to the need for such increases are discussed in detail below. As a result of these increases, monthly costs associated with solid waste, water, and wastewater services for an average residential customer will increase by 4.6% overall. It is important to note that even with the rate changes, Sunnyvale residents enjoy utility rates that are 29.5% lower than the average of surrounding communities. This amounts to annual savings of approximately $346 per household.

There is one enterprise fund that requires an annual transfer from the General Fund for operations because it is not fully sustaining. The Community Recreation Fund incorporates Leisure Services activities including golf, tennis, and recreation programs. The decision to utilize an enterprise fund approach for these programs was based on two factors. First is the existence of competition in the marketplace. Users of Leisure Services have a wide variety of other options to supply these services. Second is the desire that these programs be managed in an environment similar to the market. By this, we mean that issues of pricing, marketing and appropriate service niches are more applicable for these kinds of activities than for other City services.

### Water Supply and Distribution Fund

The Water Supply and Distribution Fund accounts for all revenues and expenses related to the City-operated water utility. Expenses include costs for wholesale water, project-related costs, debt service, and other operating costs. Revenues consist of service fees for water and recycled water, water-related public works and construction fees, and interest income. Once expenditure levels are developed, then water rates must be set to maintain the fund in a sustainable financial position. The fact that

Sunnyvale utilizes long-range financial planning and sets utility rates every year helps minimize wild rate swings.

Sunnyvale currently receives water from four different sources. Approximately 42% comes from the San Francisco Public Utilities Commission ("SFPUC"), 46% from the Santa Clara Valley Water District ("SCVWD"), 6% from well water, and the remaining 6% from recycled water.

A significant portion (66.8%) of the Water Fund's direct expenditure budget is the cost of purchased water, so each year staff reviews the costs of wholesale water and the quantities planned to be purchased. The City purchases water from two wholesalers: the San Francisco Public Utilities Commission ("SFPUC") and the Santa Clara Valley Water District ("SCVWD"). Currently, we are paying $479 per acre-foot to SFPUC, and $460 per acre-foot to SCVWD.

Prior to preparing a Twenty-Year Water Forecast, staff obtains projections from each of the City's water wholesalers for next year and beyond. In general, each of the City's suppliers provides price projections for a one to ten year period. Staff then takes these numbers, factors in all known price increases, and projects water usage over the long-term plan to optimize the use of the least expensive sources of water within the terms of the contracts.

For the first five years of the Forecast, staff maximizes the use of SFPUC water to take advantage of the benefit provided by a rebate for recycled water. Starting in the seventh year (FY 2010/2011), the Forecast maximizes the use of well water, which is currently the City's most cost-effective source of water. However, the bulk of the water must still come from our wholesale suppliers as the wells are only able to generate a limited amount of acre feet before the power costs drive the unit cost for the water above that which is available from our wholesalers. At this same point, the projected acre feet taken from the SFPUC and SCVWD are essentially flattened for the remainder of the 20-year period with the continued increases in the use of well water to meet the projected demand in FY 2023/2024.

The recommended FY 2004/2005 Budget assumes increases of 5% for SFPUC and 7.6% for SCVWD, based on initial projections received by staff in April. The Budget also includes projections provided by SFPUC for nine additional years and by SCVWD for four more years. It should be noted that the SFPUC is projecting substantial rate increases in FY 2009/2010 through FY 2011/2012 to reflect completion of their ambitious Capital Plan. The projections provided by each agency are as follows:

| | SFPUC | SCVWD |
|---|---:|---:|
| FY 2004/2005 | 5.0% | 7.6% |
| FY 2005/2006 | 6.0% | 8.1% |
| FY 2006/2007 | 6.0% | 6.5% |
| FY 2007/2008 | 6.0% | 7.9% |
| FY 2008/2009 | 12.0% | 7.3% |
| FY 2009/2010 | 18.0% | |
| FY 2010/2011 | 12.0% | |
| FY 2011/2012 | 13.4% | |
| FY 2012/2013 | 6.0% | |
| FY 2013/2014 | 6.0% | |

Our experience tells us that the projections from the SFPUC are particularly unreliable, and subject to frequent change. In fact, after our rate-setting process in April, staff received word that the increase from SFPUC would be 2.7% instead of the projected 5%. Beyond the first year, the projections from SFPUC have been adjusted by staff to be no less than 6% to mitigate potential fluctuations in cost due to wildly varying SFPUC rates.

A major potential influence on water rates continues to be the need for significant improvement to the SFPUC's Hetch-Hetchy system infrastructure. As staff has mentioned for several years, SFPUC has identified a need for capital improvements to restore the reliability of the Hetch Hetchy system. The Hetch Hetchy system (the sixth largest in the nation) delivers an average of 206 million gallons of water per day to 2.4 million people in San Francisco, San Mateo, Santa Clara, and Alameda counties. Much of the system was built in the late 1800s and early 1900s and has reached or exceeded its life expectancy. The system crosses three major earthquake fault lines between San Francisco and its sources of water, 160 miles away in the Sierra Nevada mountain range. Seismic studies indicate that a major earthquake could cause system failure resulting in a loss of water for sixty days or more.

Sunnyvale is one of 28 jurisdictions outside of the City of San Francisco who make up approximately 70% of the system's customers (the "Suburban Users"). In May 2002 the SFPUC approved a $3.6 billion Capital Improvement Program ("CIP") and in November 2002, the San Francisco voters approved a $1.6 billion bond measure, the largest ever approved in city history, to fund the San Francisco portion of the project. The remaining portion of the CIP is to be funded by the suburban Users.

The SFPUC is focused on implementing the CIP, and the projected increases in the cost of purchased water from SFPUC are due to capital improvements and related adjustments to the costs associated with program operations. The fact that the projected purchased water rates are climbing is a sign that SFPUC is beginning to implement projects that have been in the planning stages for many years.

Additionally, the recommended FY 2004/2005 Budget and Long Term Financial Plan for the Water Fund reflects a variety of capital, special and infrastructure projects totaling more than $18.6 million through FY 2023/2024. Most notable are projects to replace and upgrade the Water Supervisory Control System ($1.9 million) and reburishment of the Wright Avenue water tanks ($375,000.) Other projects include the ongoing replacement of a variety of water lines, manholes, and pumps, and security improvements at the City's well sites. The plan also provides partial funding for future projects including the replacement of water valves, pump station buildings, and the ongoing maintenance and refurbishment of a variety of water tanks and facilities.

For FY 2004/2005 the City's method of accounting for capital and infrastructure projects in the utility funds has been changed to reflect preferred practices. Previously, capital or infrastructure projects for all funds, including the Water Fund, were accounted for in the Capital Projects Fund or the Infrastructure Renovation and Replacement Fund, with transfers from each benefiting fund being made over the Long-Term Financial Plan. Beginning in FY 2004/2005, the capital projects are being accounted for within the fund itself, and the infrastructure projects are being accounted for in a separate sub-fund of the respective fund. This change is reflected on the Long Term Financial Plan in two areas. First, under *Current Resources*, transfers are being made into the Water Fund from the Capital Projects Fund and the Infrastructure Fund. These transfers are being made to return the unexpended funds for capital or infrastructure. Second, capital projects and infrastructure projects totaling about $17 million are now reflected in the Water Fund Long Term Financial Plan directly. The transfer to the infrastructure fund has been reduced to reflect only those projects that are funded by multiple funds and therefore are properly reflected in another fund.

In the recommended FY 2004/2005 Budget a special project to perform a Cost of Service Study on the City's water utility has been funded. The study will work to reallocate the costs associated with providing water to Sunnyvale customers among the various customer classes based on their use of the system. Staff also plans to have the study identify the total costs to produce recycled water, including the indirect benefits realized through reduced potable water purchases and reduced discharge of wastewater to the San Francisco Bay. The study will take the major part of the year to complete. The results will be reported as part of the FY 2005/2006 utility rate report.

Another new item on the Water Fund Long Term Financial Plan is the Municipal Utilities Infrastructure Fee. This is a new fee that was approved in concept in last year's Budget process and will take effect in FY 2004/2005. The City currently charges a franchise fee to the private utilities that operate in the City for the purposes of covering the impacts from the utility's operations on City infrastructure. A franchise fee is also charged to Specialty Solid Waste and Recycling, the holder of an exclusive franchise for providing refuse collection services within the City. The new Municipal Utilities Infrastructure Fee will be collected from City-owned utilities for their impact on General Fund assets. The Department of Finance has engaged an expert to determine the impact of the Water and Wastewater utilities on the City's street system. The completion of the study will provide recommendations as to how to allocate reimbursements to the City's General Fund that will meet the legal requirements associated with implementing a fee of this nature. Staff has programmed a total of $644,780 a year into the Long Term Financial Plans for the two utilities beginning in FY 2005/2006. This estimate is split in half between the two funds to approximate the transfers that may result from this study. These transfers are reflected for the full 20 years of the plans, adjusted for inflation.

The Water Supply and Distribution Fund Long Term Financial Plan reflects one Interfund loan from the General Fund. During FY 2002/2003 the City purchased property located at 239 Commercial Street to provide additional space for the Public Works Corporation Yard. The total purchase price of $2,530,000 was funded by the City's Water and Wastewater enterprise funds based on the number of staff located at the Corporation Yard. The Water Fund's share of the cost amounted to 64%, or $1,632,000. The Water Fund did not have sufficient funds for the purchase, and the General Fund loaned the Water Fund the total amount. The loan accrues interest of 6% starting in FY 2002/2003. Payments are deferred until FY 2007/2008 and will continue through FY 2025/2026.

The Fiscal Sub-Element of the City's General Plan calls for the Water Fund to maintain a Contingency Reserve of 25% of operations. This Contingency Reserve is to be used only in the event of disasters or other emergencies. The Water Fund also maintains a Rate Stabilization Reserve to smooth utility rates from year to year. Finally, the 20-Year Resource Allocation Plan ("20-year RAP ") Reserve serves in this fund, as it does in the General Fund, to levelize economic cycles and plan for project-related expenditures.

The rate increase approved by Council for water utility services for FY 2004/2005 is 5%, compared to the 4% anticipated last year. The projected rate increases anticipated over the remainder of the 20 years are shown at the bottom of the Water Fund Long Term Financial Plan. Also shown is the percent change in purchased water cost for each year. It is important to note that the water rate increases anticipated are in most cases significantly lower than the projected increases in the cost of purchased water.

## Wastewater Management Fund

The Wastewater Management Fund accounts for the revenues and expenses related to the City-operated sewer collection and Water Pollution Control Plant (WPCP) services.

The City owns and operates an extensive system for management of wastewater (sewage) within City limits and in a small area in northern Cupertino. The system includes approximately 327 miles of sewer pipes and a 29.5 million gallon per day ("MGD") Grade V Water Pollution Control Plant. Operations include the transport of sewage to the treatment plant, wastewater treatment, recycled water production, industrial discharge inspection and enforcement, and many other services related to wastewater. Although the WPCP has a 29.5 MGD capacity, it is currently processing about 15 MGD. One issue that will be explored in the next year is whether it would be possible to make some of this capacity available to other nearby jurisdictions to help defray overhead and provide additional revenue to this fund.

Infrastructure maintenance and replacement has been and remains the largest issue for the Wastewater Management Fund. The Long Term Financial Plan reflects large infrastructure expenditures on projects that are underway in the early years of the plan. These projects were largely funded by revenues from the 2001 Water and Wastewater Revenue Bonds,

Portions of the treatment plant and collection system are approaching 50 years in age. Staff has made significant progress in the past year identifying projects for the future and working to isolate the cost and life span of various pieces of infrastructure, both at the treatment plant and in the collection system. As they are identified, projects are incorporated into a long-term infrastructure replacement plan which will then drive the financing of the projects and ensure that all wastewater collection and treatment processes are maintained in working order. Potential funding sources are being explored with the goal of minimizing the impact of infrastructure renovation and replacement on ratepayers.

The recommended FY 2004/2005 Budget reflects this need for significant capital improvements, with $46 million programmed over the 20-year period. The major infrastructure project is the Borregas Sanitary Trunk Sewer Replacement, budgeted at $5.6 million over a three year period ending FY 2004/2005. Other significant projects include the rehabilitation of Storm Pump Station No. 1 ($1.2 million) and Replacement of the Digester Lids ($1 million over three years). The plan also provides partial funding for future projects including the replacement of sewer mains, pump station buildings, and the ongoing maintenance and refurbishment of a variety of wastewater related facilities.

As with the Water Supply and Distribution Fund, the method of accounting for capital and infrastructure projects has changed beginning in FY 2004/2005. This change is reflected in the transfers in from the Capital Projects Fund and Infrastructure Fund of unexpended funds, and the capital and infrastructure projects that are shown directly in the Wastewater Fund starting in FY 2004/2005.

Environmental regulations continue to restrict numerous pollutants, requiring additional study and increased public outreach efforts to reduce the amount of pollutants reaching the San Francisco Bay. Staff is currently undertaking efforts to renew the City's discharge permit under these more stringent requirements. In prior years, three ongoing efforts related to our National Pollutant Discharge Elimination System (NPDES) permit and the control of non-point source discharges were shown in this fund as special projects. Since they are ongoing and are actually operational in nature, these projects have been folded into operations for FY 2004/2005. This will show as a apparent sharp decrease in special projects and a corresponding increase in operations beginning next year.

As part of the City's budget process in FY 2003/2004, Public Works staff identified reductions to the Wastewater Management Program. One of these reductions was the service to maintain, repair, and replace private sewer laterals and install clean out on private sewer laterals related to street tree damage. In March 2004 Council directed staff to include restoration of this service in the recommended FY 2004/2005 Budget. This restoration is reflected as a budget supplement in the amount of $332,062. This cost has been included in calculating the proposed rate increase for FY 2004/2005.

The recommended FY 2005/2006 Budget for the Wastewater Management Fund reflects payment of a Municipal Utilities Infrastructure Fee to the General Fund in the amount of $332,390. This new fee has been discussed in more detail in the section of this Transmittal Letter dealing with the *Water Supply and Distribution Fund.*

The Wastewater Management Fund Long Term Financial Plan reflects two Interfund loans from the General Fund. In FY 1980/1981 the General Fund advances to the Wastewater Management Fund $10.7 million for the purpose of remodeling the primary facilities of the WPCP and expanding the plant capacity from 22.5 million gallons per day to 29.5 million gallons per day. The advance bears interest at 7%. Repayment of the loan has been accelerated to begin in FY 2004/2005. Payments will continue through FY 2023/2024. The General Fund also advanced an additional $2,453,635 to the Wastewater Management Fund for cash flow purposes in FY 1995/1996. Repayment of the loan is ongoing and continues through FY 2023/2024.

As with the Water Fund, the Wastewater Management Fund by policy maintains a Contingency Reserve of 25% of operations, a Rate Stabilization Reserve and a 20-Year Resource Allocation Plan Reserve.

The rate increase approved by Council for Wastewater services for FY 2004/2005 is 5%, the same as last year's projection. Annual rate increases for the remainder of the planning period are shown at the bottom of the Long Term Financial Plan.

**Solid Waste Management Fund**

The Solid Waste Management Fund accounts for the revenues and expenses related to collection, recycling, and disposal of solid waste generated within the City of Sunnyvale. A private company, Bay Counties Waste Services, doing business in Sunnyvale as Specialty Solid Waste & Recycling ("Specialty"), has been issued an exclusive franchise for collection of refuse and recyclable materials, and these contract costs are reflected here. Operations of the Sunnyvale Materials Recovery and Transfer Station and disposal of refuse at the Kirby Canyon Landfill are included in a separate fund, but the City's share of these activities is reflected in the Solid Waste Management Fund.

In budgeting for municipal solid waste management expenses, the most significant factor influencing revenues and expenses are tons of solid waste collected, transferred, and disposed. Staff begins preparation of the Solid Waste Long Term Financial Plan by projecting the amount of material that is anticipated to be delivered to the SMaRT Station. For forecasting purposes, staff has separately projected residential and commercial/industrial tonnage. Residential projections are based on new housing forecasts and are expected to remain relatively flat. The commercial/industrial forecast is based on the 8-year economic cycle of tonnage that is reflected in historical data for the Solid Waste Fund. Revised tonnage projections for FY 2004/2005 have remained fairly flat from last year's anticipated projections, dropping only 2%. As mentioned earlier, tons increase and decrease trending the assumed economic cycle.

One current issue that has been reflected in the recommended FY 2004/2005 Budget for the Solid Waste Fund is the proposed extension of the Specialty contract. In November 2003 City Council adopted alternatives to approve a change to the depreciation schedule for Specialty's trucks and equipment, and directed the City Manager to negotiate and return with a contract amendment that extended the term of the contract. At that time, Council also directed that a detailed performance review of Specialty's operations be undertaken by the City. The proposed FY 2004/2005 solid waste utility rates incorporate the effects of this council action. The proposed extension of depreciation manifests itself as a savings in the yearly contractor payment. The Long Term Financial Plan also anticipates the receipt of $1,043,830 in one-time accrued depreciation savings from Specialty in FY 2004/2005.

One new cost reflected in the Solid Waste Fund Long Term Financial Plan starting in FY 2004/2005 is a charge for rent for use of the land that the SMaRT Station occupies. The SMaRT Station is located on a parcel of land also occupied by the landfill that records indicate was originally purchased by the City with the intent of establishing a park. The facility resides on 9.5 acres of land. Currently the City's

General Fund receives no revenue from the Solid Waste Management Fund's use of this land, even though the Solid Waste Fund receives a benefit for its use. Taking into consideration the location and values of comparable land, staff is recommending that the General Fund be reimbursed $11.25 per square foot for the use of the land, for a total payment of $333,602. This payment is reflected for the full term of the plan, adjusted for inflation.

The Solid Waste Management Fund Long Term Financial Plan reflects one Interfund loan from the General Fund and one Interfund loan from the Water Supply and Distribution Fund. From FY 1984/1985 through FY 1988/1989 the General Fund advances a total of $14,185,152 to the Solid Waste Fund for the construction of the landfill methane gas collection system and for stabilization of rates over the long term. The advance bears interest at 7%. Repayment of the loan has been accelerated to begin repayment in FY 2004/2005. Payments will continue through FY 2023/2024.

During FY 1993/1994 the Water Fund advanced $1,707,698 to the Solid Waste Fund to finance a portion of the cost to place a final cover on the City's landfill. Payoff of the loan in full has been programmed for FY 2004/2005.

By fiscal policy, the Solid Waste Fund maintains a Contingency Reserve of 10% of operations. This is less than the 25% required for the other two utility enterprises to reflect that fact that this operation has less risk for damage or disaster. The Fund also maintains a Rate Stabilization Reserve and a 20-Year Resource Allocation Plan Reserve similar to the other utilities.

The rate increase adopted by Council for FY 2004/2005 is 4.0%, half a percent less than planned last year. The projected rate increases for the remainder of the planning period are reflected at the bottom of the Solid Waste Management Fund Long Term Financial Plan.

## Sunnyvale Materials Recovery and Transfer (SMaRT) Station

The Sunnyvale Materials Recovery and Transfer Station Fund consists of two sub-funds. The SMaRT Station Fund accounts for operations at the SMaRT Station and receives its revenue from charges to the cities of Sunnyvale (Solid Waste Management Fund), Mountain View, and Palo Alto. Major operating cost components include the contract with the SMaRT Station operator and disposal fees and taxes collected by the Kirby Canyon Landfill. The fund is designed so that annual revenues and expenditures are in balance and that no fund balance is carried forward to the next year. Operating costs and revenues from the sale of recyclables are charged to or distributed to the cities based on the numbers of tons of solid waste each community brings to the SMaRT Station for materials recovery, transfer, and disposal.

The SMaRT Station Replacement Sub-fund provides for the replacement of City-owned SMaRT Station equipment. The three participating cities contribute to these replacement efforts and to payment of debt service based on fixed percentages established by the SMaRT Station Memorandum of Understanding (MOU) among the cities.

In February 2003, the City completed the sale of the City of Sunnyvale Solid Waste Revenue Refunding Bonds, Series 2003. The transaction produced net present value savings of $1,231,530.93, or 6.756% of the par amount of the refunded bonds. The majority of the savings occur in the final year of debt service when the payments are covered by the reserve fund and reserve fund earnings. The savings are distributed to each of the three cities based on their share of the debt service established under the MOU. Sunnyvale will realize approximately $681,000 in savings over the life of the bonds.

The SMaRT Station Fund shows decreases in both revenues and expenditures over the planning period based on updated tonnage projections submitted by all three participating cities. SMaRT operations are affected by the same economic conditions that were discussed earlier in relationship to the City's Solid Waste program. Large swings in tonnage projections are anticipated to be seen in future SMaRT Station Fund Long-Term Financial Plans in response to economic cycles, the independent solid waste management strategies of the three cities, and other factors.

The recommended FY 2004/2005 SMaRT Station Long Term Financial Plan reflects debt service for the original cost of the facility through FY 2017/2018. The MOU with Palo Alto and Mountain View continues through October 2021. Staff projects that while most of the equipment can be maintained in good working order through the term of the MOU, there will come a point when major equipment and the structure itself will need replacement. When the end of the MOU term approaches, Sunnyvale will begin the process of exploring various refuse transfer and disposal options that are available on the market at that time. The most likely option at this juncture is the refurbishment or replacement of the SMaRT Station. Staff will consider this issue again during the FY 2005/2006 Budget process and reflect any changes that may affect the City financially in the Long Term Financial Plan.

## Community Recreation Fund

This fund, which was created in FY 1991/1992, contains the leisure service activities of the City, including the two City-operated golf courses, the tennis center, and recreation classes and services. Prior to the initiation of the Fund, leisure services were part of the General Fund. The creation of the Community Recreation Fund included the merger of the City's golf and Tennis Center operations with the remainder of all other leisure service activities, as well as the adoption of new, entrepreneurial approaches to service delivery. This approach resulted in a significant reduction in the General Fund subsidy that would have been required to support leisure services in Sunnyvale going forward.

The recommended FY 2004/2005 Budget for the Community Recreation Fund includes a number of key issues for Council consideration, as discussed below.

### Golf Services

Golf operations continue to be the greatest single source of revenue for this Fund, providing over $1.7 million of net profit to the Fund in FY 2002/2003 to support other subsidized recreation services. Sunnyvale's golf courses are on track to again generate a substantial overall profit for FY 2004/2005. However, the general decline in the local and state economy has definitely had a negative effect on golf play, and that will be reflected in year-end results. Staff estimates that the combined courses will generate several hundred thousand dollars less in green fees than planned for this fiscal year. As a result of this decline in play and impacts on the local economy, Council acted in March of 2004 to postpone increases in green fees previously planned to go into effect in April 2004.

Future year projections of golf revenues also take into account the national golf industry's trend toward increased numbers of golf courses without corresponding increases in rounds of play. This is a trend we expect to experience as well, with several new courses developed or renovated in this area, and a projected decrease in golf rounds as a result. Council's continued support of market-based golf fees regardless of residency or age (with the exception of monthly discounts for residents and seniors) remains a critical factor in maintaining this important revenue stream.

Senior Lunch Program

During FY 2003/2004 staff began to implement changes in the provision of the City's Senior Lunch Program that had previously been communicated to Council. Specifically, staff began to explore contractual arrangements with private caterers whereby they would provide the Senior Lunch Program at a much reduced cost in exchange for the privilege of exclusive catering rights for Community Center and Senior Center functions. A local catering firm has entered into a pilot program that will expire at the end of FY 2003/2004. Staff anticipates negotiation of a longer-term agreement with this firm that will essentially eliminate all but $4,000 of the City's costs for the Senior Lunch Program. The recommended FY 2004/2005 Budget reflects this assumption, which results in a cost reduction of $135,000 for senior services. While change can be difficult, staff believes that this arrangement will serve to protect and maintain services important to our senior community, even in the face of our reduced fiscal circumstances.

Fee Waiver Program

The fee waiver program is an important component of the City's delivery of leisure services. It allows the economically disadvantaged to participate in programs by defraying the established user fees. During FY 2003/2004 the amount of fee waivers allowed per individual each year was increased to $250 to keep pace with inflation. To date, Sunnyvale Community Services ("SCS") has administered the City's fee waiver program at no cost. However, SCS also received significant financial assistance from the City in the form of free rent at the old Senior Center on McKinley Avenue. Since SCS has moved to a new facility and is no longer receiving on-going rental assistance from the City, it has indicated it can no longer afford to shoulder the full cost of administering the fee waiver program. Staff will work in FY 2004/2005 with SCS to determine how the fee waiver program can continue at no additional expense to the City. Both staff and SCS believe a collaborative relationship between the two parties will continue to exist, but that the role of SCS will focus more on qualifying individuals for assistance while City staff restructure to absorb functions related to program registration and tracking participation.

General Fund Subsidy

The recommended FY 2004/2005 Budget provides $10.5 million worth of diverse leisure services to the community with a total subsidy from the General Fund of $3.1 million. Approximately $930,000 of this subsidy is returned to the General Fund to cover administrative in-lieu costs, making the net subsidy $2.2 million. When the Community Recreation Fund was established in FY 1991/1992 the General Fund subsidy was approximately $2 million, with $91,000 returned to the General Fund for in-lieu charges. When converted to today's dollars, the same level of subsidy would be $2.8 million, and the in-lieu charges would be $126,000, for a net subsidy of $2.7 million. As this information indicates, over the intervening years the subsidy has held constant and in fact reduced slightly. This has occurred in spite of the fact that the service level approved by the Council has increased (e.g. teen services, Fremont Pool, new Senior Center.)

However, regardless of how well this Fund operates, the fact that it requires a subsidy and is dependent upon the General Fund necessitates that it be examined during times of fiscal crisis or retrenchment. A fundamental tenet of this Fund is that it can always reduce costs to the point of becoming self-sufficient by reducing or eliminating services. The dilemma, of course, is that the services that would need to be eliminated to achieve a reduction in the subsidy are those that are the least attractive to reduce from a public policy perspective. They are those that serve our youth, senior, disabled and low-income populations. Most other recreational programs pay for themselves or generate a slight profit.

Structural Imbalance

The recommended FY 2004/2005 Budget is balanced using a General Fund transfer of $3.1 million, the same level as projected last year. However, this is not sufficient to cover the full difference between revenues and expenditures in this fund. Absent any corrective actions, the General Fund transfer would be about $300,000 more than anticipated last year starting in FY 2004/2005, and grow over time. Given the City's current new fiscal realities, staff has retained the General Fund subsidy at its previously projected levels and inserted a new line in the Long Term Financial Plan entitled "*Fiscal Strategies.*" This line, shown under *Current Requirements*, reflects the fact that the Community Recreation Fund will have to decrease its expenses (or increase its revenues) by $318,090 starting in FY 2005/2006 in order to continue to be in balance and not draw further on the General Fund. Staff anticipates that the Community Recreation Fund will end the current year with about $300,000 in the 20-Year Resource Allocation Plan Reserve. The Budget proposal utilizes this reserve to balance the Fund for FY 2004/2005 while staff develops a plan to decrease expenses by the needed amount. Staff believes that this is possible by utilizing the following strategies:

- **Manage demand so as not to increase services unless they are self-sufficient**
- **Maximize Golf revenues**
- **Explore alternate ways of providing subsidized services at a lower cost**

- **Continue creative partnerships with outside groups to reduce costs**

  **Maximize other Community Recreation Fund revenues by charging market based fees wherever possible**

Staff will be looking at these strategies during FY 2004/2005 and will return to Council with recommendations designed to contain or reduce the General Fund subsidy while minimizing reductions in services to the City's youth, seniors, economically disadvantaged and disabled populations.

The recommended FY 2004/2005 Budget and Ten-Year Resource Allocation Plan includes no new capital projects in the Community Recreation Fund. The Fund contains two small reserves. The first, *Co-op Sports Reserve*, reflects requirements of a contract that the City has with the Sunnyvale School District to administer the after school intra-mural sport league programs at Sunnyvale Middle School and Columbia Middle School. The reserve carries over funds for the Sunnyvale Middle School program, which generally brings in more revenue from participant fees than is needed to cover direct program costs. The reserve funds are used to purchase equipment and uniforms as needed by the school.

The second reserve is the 20-year Resource Allocation Plan Reserve, which functions here as in other funds, to levelize expenses and revenues over the planning period.

## SPECIAL REVENUE FUNDS

Special Revenue Funds are used to account for the proceeds of specific revenue sources that are legally restricted to expenditures for specified purposes.

### Housing Fund

The Housing Fund is comprised primarily of revenues from federal HOME grants, housing mitigation funds, and Below-Market-Rate ("BMR") receipts. Expenditures are for capital and special projects targeted to achieve the goals of the City's Housing and Community Revitalization Sub-Element of the General Plan and the 2000-2005 Consolidated Plan. The Consolidated Plan is a five-year comprehensive planning document submitted to the federal government. It identifies a jurisdiction's overall needs for affordable housing and non-housing community development. The federal government requires the City to submit annual updates during the intervening years of the Consolidated Plan, and this is generally done in May of each year.

#### Housing Mitigation

Housing mitigation funds are maintained in a separate sub-fund, accruing interest solely for housing mitigation purposes as required by law. This fund shows receipts through FY 2004/2005, reflecting the final payment from Applied Materials for the fees on their Arques campus development. As with other grant funds, our Long Term Financial Plan includes only development approved to date.

For FY 2004/2005 the Housing Mitigation Sub-fund has two other specific sources of revenue. The first is a Housing Loan Repayment in the amount of $350,000. This represents the portion of a bridge loan to the Emergency Housing Consortium that will come due next fiscal year. The second revenue, Real Property Sale, represents the sale of four housing units that were purchased in forced sales to maintain the City's Below Market Rate housing stock.

Interest income on the reserve balances in this sub-fund continues to accrue and is available for programming to future housing mitigation projects.

Beginning in FY 2001/2002, Council appropriated Housing Mitigation funds for the Housing Assistance for Teachers and City Employees project. The program consists of three components: Homebuyer Education, Security Deposit Loan Program and Down Payment Assistance Program. Staff has proposed an additional $230,000 for this project in FY 2004/2005 and $200,000 a year thereafter for the entire Long Term Financial Plan.

Also beginning in FY 2004/2005 staff has programmed a line entitled *Future Housing Mitigation Projects* to serve as a placeholder for the Housing Mitigation Fund's portion of three significant housing projects. Funds in the amount of $830,000 are identified for FY 2004/2005 for potential projects for Preservation of at Risk Affordable Units, Acquisition of Existing Properties for Loans to Non-Profits, and the Plaza de las Flores Acquisition. Staff will be coming to Council in FY 2004/2005 with more details to seek Council approval for these efforts. Additional funds of $830,000 are shown as future project requirements through FY 2007/2008.

Also proposed for FY 2004/2005 is a transfer to the Other Grant Sub-fund of the Housing Fund to move a deposit made a number of years ago into the proper account. Haseko Residential Inc. made a $1.8 million Below Market Rate ("BMR") in-lieu contribution for the Lawrence/101 development project in 1991. In FY 2002/2003, staff identified the need to segregate these funds with accrued interest to ensure that the money is properly used for BMR related activities. As of the end of FY 2003/2004 it is expected that these funds will total $2,769,741, and they have been placed into a BMR In-Lieu Reserve. In FY 2004/2005 the funds are shown as transferred into the sub-fund of the Housing Fund that handles all BMR activities.

Following the proposed transfer of the BMR funds, the Housing Mitigation Sub-fund is projected to have a Housing Mitigation Reserve balance of approximately $5.9 million.

HOME Fund

HOME funds are also maintained in a separate sub-fund of the Housing Fund. The City has been notified that its allocation of these monies for FY 2004/2005 totals $777,156. Including program income received to date, $1,166,644 is being recommended in FY 2004/2005 for the following activities: Operations ($77,643), Community Housing Development Organizations ("CHDO") Project ($151,573), First Community Housing Project ($328,138), and Future Home Projects ($609,290). The last project includes the remaining HOME monies that are not designated for specific projects but generally target the goals of the City’s General Plan and the 2000-2005 Consolidated Plan.

Other Grant Supported Housing

Finally, the Housing Fund has a third sub-fund that contains BMR and other grant-supported housing activities. Revenues in this sub-fund include housing monitoring fees, revenues from BMR code violations, and interest earnings. The transfer from the Housing Mitigation Sub-fund mentioned above is also reflected here for FY 2004/2005. Expenditures are operating costs associated with maintenance and monitoring of the BMR program ($57,955) and two special projects ($580,400). One on-going special project in this sub-fund provides for the auditing of BMR participants to ensure compliance with program regulations. The second special project provides $540,000 each year from FY 2004/2005 through FY 2007/2008 for First-Time Homebuyer Support.

The Other Grant Supported Housing Sub-fund maintains two reserves. The first is the BMR In-Lieu Reserve discussed above which is to be used for BMR related activities. The second is the 20-year Resource Allocation Plan Reserve which is used here as in other funds to levelize spending or provide funds for capital expenditures.

## Community Development Block Grant Fund

The Community Development Block Grant Fund is comprised of revenues from Community Development Block Grants and the repayment of commercial and residential loans. In prior years, the fund had rental income from a residential property that it owned, but the Long-term Financial Plan shows this property being sold in FY 2004/2005. Primary expenditures are for operations, housing opportunities, special projects, and most of the City's outside group funding efforts.

On the revenue side, Community Development Block Grants are shown through FY 2004/2005. The Federal Government has notified the City that its FY 2004/2005 entitlement will be $1,504,000. Similar to the long-standing strategy used with all federally financed programs, future grant receipts are not shown beyond the immediate planning horizon. When and if these entitlements are no longer provided, expenditure levels would drop considerably. At that time, Council would have to make determinations as to where the priorities will be regarding the relatively small amount of income that would continue to be available on an annual basis from loan repayments.

Traditionally, CDBG funds are used primarily to address the City's affordable housing strategy. This includes support of housing and human service agencies; rehabilitation and retrofitting of the existing housing stock; and the acquisition, rehabilitation, and construction of affordable housing by non-profit developers. As in the Housing Fund, capital and special projects are targeted to achieve the goals of the City’s Housing and Community Revitalization Sub-Element of the General Plan and the 2000-2005 Consolidated Plan. By regulation, CDBG funds may be used for programs or projects that benefit groups with special needs such as senior and handicapped citizens. During FY 2004/2005 staff will be working to evaluate the possibility of using the

Housing Mitigation and HOME funds for the City's affordable housing expenditures and utilizing CDBG funds more extensively for these special needs communities.

The recommended FY 2004/2005 Budget includes $313,193 for Outside Group Funding of sixteen local agencies. Special projects are proposed in the amount of $1,361,219, including $100,000 for the City's ADA Curb Retrofit project. Details of the Special projects are included in *Volume II, Projects Budget.*

**Park Dedication Fund**

The Park Dedication Fund was established to meet statutory requirements regarding the accounting for park dedication monies. In general, the City collects park in-lieu fees for multi-family residential projects that do not dedicate land for use as parks or open space. Those revenues are recognized in the Park Dedication Fund, and then available resources are transferred to the Capital Projects Funds for designated and approved park-related projects. Revenues in this Fund also include rental income from certain houses that the City purchased with Park Dedication Funds in anticipation of park expansion projects.

Some years ago, the methodology for determining park in-lieu fees included a determination of fair market value on a project by project basis. This process was sometimes contentious and time-consuming for both the project proponent and staff. In 2000, Council approved an alternative methodology for determining park in-lieu fees that eliminated the need to determine fair market value on a project by project basis.

In past years, this fund was earmarked to help cover the costs of approved park-related projects. Projects have included both the renovation of existing parks and the addition of new parks. The City has never relied on this fund in order to plan its open space projects. In other words, park projects have been planned on the basis of community need as opposed to the amount of funding available in the Park Dedication Fund. In fact, the General Fund has funded the vast majority of past park projects, with the Park Dedication Fund simply an additional funding mechanism to periodically offset costs planned in the General Fund.

In FY 1999/2000 the City received over $1.4 million in Park Dedication Fees in relation to three large residential projects (the Irvine Apartments on the Olson property, the Villa del Sol apartments at Sunnyvale and Evelyn Avenues, and the Las Palmas homes on the Stowell property). No Park Dedication Funds were received in the intervening time period through FY 2002/2003. However, in FY 2003/2004 a number of large residential projects have been undertaken and the City has received about $1.9 million to date. Staff from the Community Development Department also indicate that an additional $1.6 million is on track to come in during FY 2004/2005 and a similar amount in FY 2005/2006. In general, the concept in this fund is that the City cannot count on, nor predict, this revenue stream. Therefore, appropriations will only follow the actual receipt of Park Dedication Fees or approval of residential projects subject to Park Dedication Fees.

The Park Dedication Fund also receives rental income from six houses that the City purchased in anticipation of expanding Murphy Park and Orchard Gardens Park. Currently, neither expansion project is funded in the Capital Improvement Program, and so the rental income has been included for the full twenty years of the planning period.

The largest single appropriation of Park Dedication Funds has been for the design and construction of a new Downtown Plaza Park at Evelyn Avenue and Frances Street. Funds have been made by way of a transfer to the Capital Projects Fund, which is accounting for the Downtown Plaza project. Discussion of this project and progress to date is included in the *Major Project Efforts* section of this Transmittal Letter. Park Dedication Funds appropriated to the Plaza Project total $4,632,482. Park Dedication Funds have also been used for the Fair Oaks Skateboard Park and Playground Improvements at Ortega Park.

By the end of FY 2004/2005 it is estimated that the City will have $2.5 million remaining in this fund's Park Dedication Fee reserves after appropriations have been made for the projects mentioned above. In order to maximize our General Fund dollars during this difficult financial time, we are proposing that additional Park Dedication Funds be appropriated to the Plaza Project and General Funds removed. We are further recommending that Park Dedication Funds be appropriated to the Historical Society Museum Project. A budget modification will be presented to Council late in FY 2003/2004 to propose these changes, and if approved will be included in the adopted FY 2004/2005 Budget. Meanwhile, the recommended General Fund Long Term Financial Plan includes a transfer of $1,250,000 from the Capital Projects Fund to the General Fund to reflect the substitution of Park Dedication Funds to the Plaza project.

## **Asset Forfeiture Fund**

The Asset Forfeiture Fund was established to account for monies received through drug and other law enforcement activities as allowed under Federal and State asset forfeiture guidelines. The purposes for which asset forfeiture can be used are limited, and funds are drawn down for new one-time expenses targeted for law enforcement services. As this is done, caution should be used to assure that these expenses are ones that fit into the City's priorities and that don't lead to unnecessary future liabilities.

The recommended FY 2004/2005 Budget includes one small operating expense in this Fund to cover allowable ongoing costs related to the yearly asset forfeiture audit. In addition, it includes a continuing transfer to the General Fund to support juvenile diversion activities within Police Services.

## **Police Services Augmentation Fund**

The Police Services Augmentation Fund is closely related to the Asset Forfeiture Fund. This fund accounts for two grant programs that provide monies for law enforcement purposes. The first is the Supplemental Law Enforcement Services ("SLES") program established by the State, and the second is a small Federal block grant from the

Bureau of Justice Administration ("BJA").

The State SLES monies constitute the major portion of this Fund. The City first received the SLES grant in FY 1996/1997. Over the years, the amounts of both grants have decreased significantly, as shown in the table below:

| | FY 96/97 | FY 97/98 | FY 98/99 | FY 99/00 | FY 00/01 | FY 01/02 | FY 02/03 | FY 03/04 |
|---|---|---|---|---|---|---|---|---|
| SLES | 293,461 | 297,886 | 295,694 | 295,117 | 289,000 | 267,997 | 263,782 | 197,376 |
| BJA | 63,935 | 68,768 | 70,158 | 52,915 | 41,718 | 41,198 | 33,685 | 25,997 |

Initially the monies were used to fund a full-time Domestic Violence Investigator, a Patrol Watch Commander, and participation in the State Bureau of Narcotic Enforcement's Bay Area Regional Narcotics Task Force. Beginning in FY 1999/2000 Council approved use of the SLES revenue to fund the Patrol Watch Commander and two Internal Affairs Investigators. Due to the continual decline of funding and increased personnel costs, by FY 2003/2004 the grants were no longer able to support the three positions and funds were allocated to the Patrol Watch Commander and a portion of an Internal Affairs Investigator. The recommended FY 2004/2005 Budget supports only the Patrol Watch Commander with SLES/BJA funds. The Internal Affairs Investigator has been moved to the General Fund operations of the Department of Public Safety.

The financial plan for the Police Services Augmentation Fund reflects revenue only for the two year operating cycle (FY 2004/2005 and FY 2005/2006) because the grants are speculative in nature. Although the State SLES funds have been targeted as a possible reduction in funding to local governments, as of the Governor's May Budget Revision they are still in the State budget. Reserves in the Fund will be depleted by the end of FY 2003/2004. If the grant funds go away or are reduced significantly, it is important to note that a Patrol Watch Commander position will be reduced accordingly from the Department of Public Safety Budget.

**Employment Development Fund**

The City of Sunnyvale, as administrative entity for the North Valley (NOVA) Job Training Consortium, is required by legislation and regulations to account for the use of various Federal and State funds and program revenues for the workforce development activities that are conducted for the consortium. The City has established the Employment Development Fund to fulfill this obligation.

NOVA, formed in 1983, serves the cities of Cupertino, Los Altos, Milpitas, Mountain View, Palo Alto, Santa Clara and Sunnyvale, and is administered by the Department of Employment Development of the City of Sunnyvale. NOVA programs receive no General Fund resources. NOVA has a wide variety of programs funded through various vehicles, with baseline funding originating from the Federal government and passing through the State of California. A significant amount of additional grant money is received from Federal and State sources, as well as the County of Santa Clara, local companies and foundations. Since July 1, 2000 the primary funding for the Department of Employment Development/NOVA has been allocated through the Workforce Investment Act (WIA).

In FY 2003/2004 funding reductions in several grants and the elimination of several Federal, State of California and private foundation funding streams caused the actual revenues available to be significantly less than anticipated, and less than projected at the beginning of the year. To manage this budget shortfall several actions were taken: the elimination of discretionary spending on such items as participant skill training, the reduction of staff by ten positions, and encouraging staff to take voluntary time off. As a result, NOVA's actual revenues will cover all actual expenditures for the current year.

The WIA-allocated funds for NOVA for FY 2004/2005 have just been released by the State of California. Even though the State of California received an allocation from the Federal government of approximately the same amount as in FY 2003/2004, NOVA's allocation increased by 17% to $4,420,177 reflecting the continued increase in the demand for re-employment services in our region. In addition to these allocated funds, NOVA has a long history of being very competitive for additional Federal and State resources and has several grant applications in place. It is projected that at least $5 million in supplemental funding will be secured during FY 2004/2005. As in the past, staff will monitor the actual expenditure/revenue rates on an on-going basis and make the required adjustments as needed.

For the purposes of the City's recommended FY 2004/20054 Budget, we have taken the funds that were available in FY 2003/2004 and used these as a starting point for NOVA's FY 2004/2005 programs and service levels. It is important to note that the Department has not yet migrated to the outcome management format. As different grants come and go, various programs and activities have a relatively short lifespan relative to other City departments. Therefore, the current listing of programs that have operated during the last several years are not included in this recommended Budget. Rather, a base funding level will be carried into the new fiscal year and the City Budget will be modified for planned activities, outcomes and expenditures during the course of the year as new funding is secured.

*Volume II, Operating Budget*, does contain descriptions of the significant NOVA programs and a summary table of the expenditures and budgets for these programs. The summary table presents two years of actual expenditures, the current budget, and the proposed budgets for FY 2004/2005 and FY 2005/2006. The proposed budgets include funds that were awarded in previous years but allocated over several years.

As in the past and in keeping with the City policy for grant-funded programs, the Employment Development Fund Long-Term Financial Plan reflects grant revenues only for the immediate planning period.

**<u>Parking District Fund</u>**

The Parking District Fund is a small fund that provides for the ongoing maintenance of downtown parking lots as well as the retirement of outstanding debt obligations utilized to purchase land and make improvements.

The Downtown Parking District includes all public parking in the downtown area with the exception of the parking structure adjacent to the Sunnyvale Town Center, which is under ownership of the Redevelopment Agency and leased to the shopping mall.

In previous years, the Parking District Fund had two revenue sources. The first was property tax to pay outstanding bonded indebtedness and special assessments to pay for ongoing maintenance.

Annual debt service for the Parking District Bonds was approximately $70,000, with the final payment made on July 1, 2003. As mentioned above, annual debt service has been funded by ad valorem property taxes.

The approval of Proposition 218 had a significant effect on the methodologies utilized to raise assessments to fund maintenance and operations within the Parking District. Proposition 218 not only deals with the approach and methodologies to be used for benefit assessments, but also the approval process. Essentially, after a method has been selected, a vote occurs by those who would be assessed, with votes weighted according to the amount of assessment. If this weighted majority does not approve the assessment, then it does not go forward.

Beginning in FY 1998/1999, voters in the District approved the new assessment methodology and have assessed themselves annually for operation and maintenance. In 2002/2003, property owners approved a two-year assessment that extended through FY 2003/2004, and another vote for a two-year assessment will be taken in June for FY 2004/2005 through FY 2006/2007.

In the near future, the various new developments now occurring or planned in the downtown area are likely to change the character of the parking assessment district, making it extremely difficult at this time to project expenses and revenues into the future. Therefore, the Parking District Fund Long-Term Financial Plan shows that the assessment revenue remains the same over the remainder of the planning period. Once the existing *20-year RAP Reserve* funds are exhausted in FY 2011/2012, operational expenses are shown as decreasing to equal special assessments. It should be noted that once all of the various factors related to parking in the downtown are defined and stabilized, the Parking District may be reconfigured considerably.

It should be noted that the lot located on the corner of Charles Street and Evelyn Avenue is not included in the maintenance assessment and will not be maintained with Parking District Funds. Costs of maintaining this lot are currently reflected in the Public Works Department Public Parking Lot Maintenance program. Although this lot was acquired with parking district bonds, it was not effectively serving the properties within the parking district. Parking District property owners expressed concern that it was primarily used by CalTrain riders, and in FY 2001/2002 it was removed from the Parking Maintenance District Assessment. The Parking District participants still have concerns that parking district bonds were used to purchase the lot and it no longer serves the needs of the Parking District. In FY 2004/2005 and ongoing we will need to resolve the issue of ownership and responsibility for maintenance of the Charles Street Lot.

Two issues regarding the Parking District Fund must be stressed. First, <u>the level of service in this area is set by the property owners, not by the City</u>. Depending upon their desire for various services and their willingness to pay, the Parking District members can have more or less services included in their assessment. The second important issue concerning the Downtown Parking District is the <u>continuing threat that the voters will not approve the assessments at some point in time</u>. It is likely that those who framed Proposition 218 did not consider its impact in situations such as this. Downtown merchants rely on this parking, and obtained authorization to operate their businesses based upon the availability of shared parking. Most have no private parking available. Nonetheless, during FY 2002/2003 the property owners did not initially approve of the assessment. A full study of options was then done in conjunction with the downtown merchants and, as a result, a second election was held that approved the assessment for two years. If, however, the assessment is not approved any time in the future, funds will not be available for continued operation of the District. In such an event, the question would be how the City would fund the District. There is no question that the cost to the merchants for publicly provided parking is far below that which would have been the case had they had to acquire the necessary land, make the required improvements, maintain the improvements, and pay property taxes on the improvements. These are costs that anywhere else in the City the private sector must bear without public assistance. It would therefore be necessary for staff to explore other potential revenue raising possibilities in the event that the assessment would not be approved. Certainly one of the alternatives is paid parking.

## Youth and Neighborhood Services Fund

The Youth and Neighborhood Services Fund accounts for the revenues and ongoing operating program expenditures associated with the management and maintenance of the Columbia Neighborhood Center ("CNC"). The Columbia Neighborhood Center was developed to meet the health, social, recreational, and education needs of North Sunnyvale residents through a coordinated network of services. The development of the Columbia Neighborhood Center was a collaborative effort between the City, the Sunnyvale School District, Advanced Micro Devices, and numerous community agencies that began in the fall of 1994. In FY 1996/1997, Council invested $500,000 as seed funding for the development of the Columbia Neighborhood Center. This was essentially the City's share of the Advanced Micro Devices contribution to Columbia Neighborhood Center. When this Fund was established, it carried with it a commitment to maintain this $500,000 to generate interest to help offset ongoing operating program expenditures. Also included in the ongoing fund balance were contributions made to the City in the amount of $6,658 on behalf of former employees that bring the current endowment total to $506,658.

At this time, only the operating program expenditures and Columbia Neighborhood Center related projects are in this fund along with the associated program revenues. As outlined in the partnership agreement with the Sunnyvale School District, a portion of the operating program expenditures are reimbursed for the youth services provided at the Columbia Middle School site. Other revenues to the Fund are Recreation Fees, interest earnings on the endowment, and an annual subsidy from the General Fund. For FY 2004/2005 the subsidy is approximately $94,000 because the Center had reserves from which to draw. For the following years, the subsidy is set at about $410,000 in FY 2005/2006 and grows with inflation over the entire planning period.

In the recommended FY 2004/2005 Budget the operating costs of the facility have been broken into separate components: the management and operations of the Columbia Neighborhood Center, the Recreation programs being conducted at the Center, and the efforts of Public Safety in Juvenile Diversion and Neighborhood Safety.

In FY 2001/2002 and FY 2002/2003 funds were appropriated for a capital project to expand the Columbia Neighborhood Center Facility. The project was dependent upon external support, largely in the form of participation by the Sunnyvale School District. The difficult financial situations of both the City and the District have made continuing with the expansion inadvisable at this time, and therefore the funding for this project was eliminated during last year's budget reduction process. It should be emphasized, however, that the Columbia Neighborhood Center is an excellent model of a program that leverages outside resources to provide significant cost-effective services to the community. In future years the City will continue to explore ways to maximizing this program.

**Redevelopment Agency Fund**

The Redevelopment Agency is a separate governmental and legal entity from the City. However, the Agency is a component unit of the City for which the City is financially responsible. Further, due to certain agreements between the Redevelopment Agency and the City, the General Fund of the City is inextricably tied to the financial condition of the Redevelopment Agency. As a result, the Redevelopment Agency Fund is traditionally covered as a part of this Transmittal Letter.

At the close of FY 2002/2003 the Redevelopment Agency had outstanding loans due to the City General Fund of approximately $45.9 million. This is largely the result of the Redevelopment Agency's inability to raise sufficient tax increment revenue to repay the City for annual lease payments made by the City for the downtown parking structure. The original financial plan established by the City Council in the mid-1970s was turned upside down with the passage of Proposition 13, which stripped the agency of approximately two-thirds of its property tax increment. Since that time, the State has enacted several laws that placed further restrictions on redevelopment agencies. These include capping the time period for collection of tax increment for each redevelopment project area; for Sunnyvale's project area, the final year is currently 2025. More important was the establishment of revenue limits for redevelopment agencies, referred to as property tax increment caps. The revenue limit/increment cap for the Sunnyvale Redevelopment Agency is $118 million. Under current conditions, it is projected that the Redevelopment Agency will never be able to completely repay the General Fund loans.

When tax increment revenues from the downtown area as it originally existed were projected, the Agency reached its increment limit just before the time limit was reached in 2025. However, the recommended FY 2004/2005 Budget now reflects the completion of the 460,000 square foot Mozart office project and the placing of new tax increment from this source on the property tax rolls over a two year period. As a result of including the increased taxes from the Mozart project, the property tax increment limit of $118 million is reached in FY 2022/2021.

The recommended FY 2004/2005 Budget and Ten Year Resource Allocation Plan for the Redevelopment Agency reflects a "base case" scenario that does not include any additional redevelopment assumptions. Currently, the Forum Development Group is proposing to completely redevelop the Sunnyvale Town Center Mall within the next two years, and the owners of the Town and Country Village development are expected to follow suit within the next five years. More information on the status of Downtown Redevelopment is included in this Transmittal Letter in the section on *Local Issues Impacting the City's Financial Condition.* Although the City is now in negotiations with the Forum Group, the Long Term projections shown here <u>do not include any of the financial effects of the development</u> since the final plans and the terms of the deal have not yet been approved by Council. Nonetheless, this base case Financial Plan can provide us with the benchmark against we will evaluate this and other development proposals to ensure that the General Fund fiscal position is maintained and enhanced.

It is important to note that to the extent that the Town Center Mall is redeveloped and development occurs on the north of Washington block, more tax increment will be produced for the Agency, which will cause the City to reach its revenue limit or tax increment cap earlier. To address the issue of the property tax increment cap, the City is currently in the process of evaluating the feasibility of amending the Redevelopment Plan to increase the revenue limit. It is expected that a potential amendment to the Plan will be brought to Council for consideration in FY 2004/2005.

The primary source of revenues to the Redevelopment Agency is Property Tax increment, which is expected to total about $3.6 million in FY 2004/2005. The effect of the Governor's May revision to his proposed budget are also shown here as a two-year reduction to the Property Tax through a shift to the Educational Revenue Augmentation Fund ("ERAF shift") starting at $264,000 in FY 2004/2005. The other major revenue source for this fund is a lease payment from the General Fund for the Mathilda Avenue Parking Structure in the amount of $1.2 million annually.

Operations for the Redevelopment Agency have been restructured in the recommended FY 2004/2005 Budget. Activities in the Economic Prosperity program managed by the Community Development Department were all previously reflected in the Redevelopment Agency Fund. Beginning next year, those activities not directly related to management of the Redevelopment Agency have been transferred to the General Fund. This reflects in a decrease in operating costs to about $200,000 annually.

Also included in current requirements are debt service payments totaling $1.8 million for the Central Core Redevelopment Project Tax Allocation Bonds and the Parking Facility Certificates of Participation. The Long Term Financial Plan also includes a repayment to the City for its outstanding loans (as discussed above) in the amount of $1.6 million in FY 2004/2005 and $2.6 million in FY 2005/2006. The Resource Allocation Plan includes a total of $32.6 million in repayment to the General Fund over the first ten years and $25.1 million in the second ten years. In spite of these payments, it is anticipated that the General Fund loan will still not be completely repaid when the Redevelopment Project expires in FY 2020/2021.

In FY 2001/2002 Council approved a capital project for improvements to the Downtown area in the amount of $1.5 million. These funds were originally generated from the sale of Parking District property for the Mozart development. Although the capital project for downtown improvements is currently funded, it has not yet been programmed. It is expected that recommendations will be developed and presented to Council for approval in FY 2004/2005.

Additional capital or special projects recommended for the Redevelopment Agency Fund in FY 2004/2005 are:

- **Town Center Demolition:** The Town Center parking structure was built in 1978. On June 2, 2003, the Building Official ordered the second level of the structure to be closed because of functional obsolescence. The cost of repair exceeds the value of the structure and therefore it should be demolished and replaced. Forum Development Group, the potential redeveloper of the Mall, has estimated demolition cost at $1,165,000. The Mall owns approximately 1/3 of the structure and is responsible for that portion of the cost. The City is responsible for approximately 2/3 of the cost of demolition, or $800,000, which has been programmed in the Redevelopment Agency Fund in FY 2004/2005.

- **Downtown Development Economic Analysis-Keyser Marston Associates:** This project will fund the economic analysis of the downtown development for the Redevelopment Agency. The project will fund the analysis of developer proformas and financing strategies which will facilitate development to the benefit of the Agency. The project will also allow Keyser Marston Asoociates to complete the negotiation of real estate transactions relating to the Town Center Mall and will include the analysis of other potential development projects in the downtown area, such as the Town and Country site. The project has been programmed in the RDA Fund in the amount of $75,000 for FY 2004/2005 and $50,000 in FY 2005/2006.

- **Outside Counsel Services for RDA:** This project will fund the outside legal services for the Redevelopment Agency through the City Attorney. Because of the increasingly complex nature of negotiations surrounding the downtown redevelopment, a special project was funded to track outside counsel services and costs. It is anticipated that significant outside legal services will be needed over the next two years to complete the Town Center Mall project and other potential development projects in the downtown area. Future projects may involve assistance on relocation agreements for sites such as the Town and Country. The project has been programmed in the RDA Fund in the amount of $100,000 for FY 2004/2005 and $50,000 in FY 2005/2006.

- **Redevelopment Plan Project Area: Economic Analysis** - This project provides for study and analysis to explore opportunities in the downtown area. Efforts will include: architectural, land planning, economic/market feasibility, parking, and financial analysis to further redevelopment in the downtown. It is anticipated that further assistance will be needed because of the increased activity associated with the development of the Town Center and future development of the Town and

Country site. The project has been programmed in the RDA Fund in the amount of $25,000 per year from FY 2006/2007 through to FY 2013/2014.

One final ongoing expenditure is programmed in the Redevelopment Agency Fund to pay the General Fund for the services of the Agency's Treasurer. These services are not charged directly to the RDA Fund, but rather are included in the General Fund.

The Redevelopment Agency Fund maintains one reserve that reflects Debt Service Reserve Funds held by the trustees for the two outstanding bond issues mentioned above.

Finally, it should be noted that the Redevelopment Agency is currently unable to make payments of 20% of its tax increment revenues to the Low and Moderate Income Housing Fund because of preexisting debt obligations. Each year, the Agency calculates the contribution that should have been made and books it as a liability in its financial statements. It is currently estimated that when the tax increment cap is reached the liability will total approximately $19.2 million. State law allows the Agency to continue collecting tax increment after the Project time and increment limits are reached to fund its housing liability. Actual payments to the Low and Moderate Income Housing Fund are reflected beginning in FY 2020/2021 until the liability is paid off.

**Patent Library Fund**

In the mid 1990s, the City and the United States Patent and Trademark Office (USPTO) formed a partnership with the City of Sunnyvale to create the Sunnyvale Center for Innovation, Invention and Ideas Sc[i]$^3$. Services and products designed and tailored to the needs of Silicon Valley inventors, intellectual property attorneys, corporate legal staff, researchers, patent agents and paralegal staff have been offered through Sc[i]$^3$ for the past eight years, and Sc[i]$^3$ has been recognized as an important contribution that the City of Sunnyvale makes to the economic development in the region, particularly during the technology boom of the late 1990s. Several years ago USPTO began to systematically make increasing amounts of patent and trademark information available electronically. This availability better addresses the preference of practitioners who prefer to work from their own offices, but has negatively affected Sc[i]$^3$ 's revenue stream. Efforts to enhance revenue through other means such as the Friends of Sc[i]$^3$ Foundation or through support from the State of California have proven unsuccessful.

Sc[i]$^3$ was downsized, redesigned and relocated to the main library in January 2002. FY 2002/2003 was the first full year of operation with a streamlined budget and reduced services under which Sc[i]$^3$ was expected to be fully self supporting. At year-end the Program fell short of its goal by approximately $20,000. The operation is very lean with a very small staff. Some of the services offered are able to cover their own cost entirely while others operate without full cost recovery. The program is constrained from covering all costs in some cases because the federal government sets the fees. Performance in FY 2003/2004 appears on track to have a deficit of between $23,000 and $30,000 (dependent on whether the entire subscription fee for the federal fiscal year is paid or a prorated amount to reflect the City's fiscal year). Several other factors contribute to the fact that Sc[i]$^3$ has a difficult time reaching full self sufficiency.

First, Sc[i]$^3$ is required to pay a subscription fee of $30,000 to the USPTO. Repeated efforts by the City Council and staff to have this fee eliminated have been unsuccessful. Second, customer input indicates that the most valuable role Sc[i]$^3$ plays is that of liaison to the USPTO. In recent years this role has been virtually eliminated. Third, the USPTO is not responsive to customer requests for training seminars on specific current topics. Fourth, very few customers take advantage of our services to provide access to the patent examiner database, EAST, or to conduct patent examinations or hearings using videoconferencing equipment. Due to this low level of use the services rarely cover their own costs.

For these reasons, there is continuing risk for the City in the operation of Sc[i]$^3$. Sc[i]$^3$ staff cannot guarantee that the operation can be self-sufficient as long as so many factors are outside their control. In assessing whether this is an appropriate risk to take, it may be valuable to consider whether residents and businesses within the City still require library-related assistance for their intellectual property concerns. It is possible that adequate alternatives exist through businesses and online access to enable them to obtain the information services they require elsewhere. If this is the case, this might be the appropriate time to acknowledge the positive contribution Sc[i]$^3$ has made to the intellectual property community in Silicon Valley and beyond and to cease the Partnership.

While these policy decisions have not yet been made, the recommended FY 2004/2005 Budget shows revenues and operating costs in the Patent Library Fund roughly equal for the entire planning period, drawing down slightly on the small 20-Year RAP Reserve each year. It is still yet to be determined whether expenditures can be contained to this extent. During FY 2004/2005 the Council will be reviewing the alternatives and making any necessary adjustment to the financial plan for Sc[i]$^3$.

## Transportation Development Act (TDA) Fund

In FY 2003/2004 a new, small special revenue fund was established to account for activities related to the Transportation Development Act (TDA) funds received from the State of California through the Metropolitan Transportation Commission. These funds are restricted for pedestrian and bicycle facilities and bicycle safety education programs and must be segregated for those purposes. In the past these funds were accounted for in the Gas Tax Fund. Although many of the projects using TDA monies are multi-funded by Gas Tax, TDA and other funding sources, they are completely different sources of funds and should not be reported in the same fund. In addition, the TDA, in accordance with Public Utilities Code Section 99245, must submit a report of a fiscal and compliance audit made by an independent auditor at the end of each fiscal year. In order to facilitate the audit and the issuance of the fiscal and compliance report, the City decided to segregate this fund into its own special revenue fund.

The recommended FY 2004/2005 Budget includes revenues of $80,000 from TDA funds based on staff's estimates using historical receipts. This revenue is included each year for the entire 20-year period, increased by inflation. The estimated new revenues are offset by an expenditure line item entitled "Future TDA Projects." When the funds are received, pedestrian and bicycle projects will be identified and funds will be appropriated. Examples of projects funded to date are Arques Avenue Bike Lanes, Sunnyvale Bicycle Network, Calabazas Creek Trail, and Countywide Bicycle Route 8 Bike Lanes.

## CAPITAL PROJECT FUNDS

Capital Projects Funds are used for major capital acquisition, construction activities, and renovation or replacement of General City fixed assets. The City currently operates two of these funds: the Capital Projects Fund and the Infrastructure Renovation and Replacement Fund. Capital and Infrastructure projects related to the Utility Enterprise Funds are budgeted and accounted for within each individual utility fund.

### Capital Projects Fund

The Capital Projects Fund was established in FY 1997/1998 to account for capital projects that are funded by the General Fund and other governmental funds or that are funded by multiple sources. The Capital Projects Fund is divided into distinct sub-funds that receive direct transfers from the funds that are responsible for the particular projects. Each sub-fund records revenues, interest earnings, transfers and expenses separately.

There are currently seven sub-funds of the Capital Projects Fund: the General Sub-fund, the Wastewater Management Sub-fund, the Water Sub-fund, the Gas Tax Sub-fund, the Measure B Sub-fund, the Traffic Mitigation Sub-fund, and the Multi-funded Sub-fund. However, beginning in FY 2004/2005 staff has changed the accounting method for capital projects related to the Utility Enterprise Funds to reflect best accounting practices. The recommended FY 2004/2005 Budget and Long Term Financial Plan for the Capital Projects Fund reflects transfers back to the Water Fund and the Wastewater Fund of monies that were previously held here for utility projects. These projects will now be completely budgeted and accounted for within each Utility Enterprise Fund. When these transfers are completed, the Capital Projects Fund will be used exclusively for the General Fund and other Governmental Funds. The only Utility Enterprise Funds that will still be budgeted here will be those that are relating to projects funded by more than one fund.

The Capital Projects Fund contains projects that are funded by external agencies such as State Transportation Surface grants, the California Energy Commission, Propositions 12 and 40 park grants, developer contributions, and transfers from various City governmental funds. In FY 2003/2004 a significant transfer was made from the Park Dedication Fund, primarily to support the Downtown Plaza Park Project.

Major project efforts included in the Capital Projects Fund are discussed throughout this Transmittal Letter under their applicable funding source. The table below is an overview of project appropriations by sub-fund for FY 2004/2005.

| *Capital Projects Fund - Project Expenditures by Sub-fund* | |
|---|---|
| Sub-fund | FY 2004/2005 Recommended Budget |
| General Fund Assets | $ 0 |
| Gas Tax | $9,040,000 |
| **TOTAL** | **$ 9,040,000** |

The appropriations for the Gas Tax Sub-Fund are comprised of two large projects. The first is the Mathilda Avenue Railroad Overpass project ($8 million) and the Bernardo Avenue CalTrain Undercrossing project ($1,040,000). It should be noted that the Long Term Financial Plan shows Capital Projects expenditures of $11,915,000 for FY 2004/2005. This reflects the fact that costs for two projects were budgeted in FY 2003/2004 but shown as being spent in FY 2004/2005 because of timing issues. These funds are Washington at Mathilda Intersection Improvements ($875,000) and Mathilda Avenue Railroad Overpass Improvements ($2 million). These funds, when added to the $9,040,000 shown on the table above, total the $11,915,000 detailed in the FY 2004/2005 Budget.

FY 2004/2005 is an "off" year for capital projects in the City's budgetary cycle. As such, there are no new projects recommended for funding in the ten year planning period. However, as discussed earlier in this Transmittal Letter in the *Future Fiscal Issues* section, the City Manager asked the Public Works Department to lead an effort this year to identify all of the City's current and future capital and infrastructure needs, funded or unfunded. As we begin the Projects Budget review cycle in FY 2004/2005, staff will be reviewing and updating this list along with various funding strategies to bring to Council for policy direction.

## **Infrastructure Renovation and Replacement Fund**

The Infrastructure Renovation and Replacement Fund was introduced with the FY 1996/1997 Budget and Ten-Year Resource Allocation Plan. Its importance has grown with each subsequent year as staff identifies projects to address the City's need to fund the renovation and replacement of its extensive physical infrastructure. This growth will continue until staff completes the Long-Range Infrastructure Plan ("LRIP").

Similar to the Capital Projects Fund, this fund is divided into distinct sub-funds that receive direct transfers from the funds that are responsible for the particular infrastructure projects. Each sub-fund records revenues, interest earnings, transfers and expenses separately. Currently the sub-funds are General, Wastewater, Water, Solid Waste, Community Recreation, and General Services. However, as noted above in the discussion of the *Capital Projects Fund*, the Utility Enterprise infrastructure projects are being moved back into each utility fund beginning in FY 2004/2005. The

Infrastructure Renovation and Replacement Fund will then be budgeting and accounting for only the General and governmental fund projects.

Major projects contained in this fund are described throughout the Transmittal Letter. The following table contains project expenditures by sub-fund for FY 2004/2005.

| ***Infrastructure Fund – Project Expenditures by Sub-fund*** | |
|---|---|
| Sub-fund | FY 2004/2005 Recommended Budget |
| General Fund Assets | $953,816 |
| Community Recreation | 195,134 |
| General Services | 0 |
| Multi-Funded Assets | 0 |
| **TOTAL** | **$1,149,130** |

There are 18 projects in the two sub-funds consisting of such items as Corporation Yard Building HVAC repair and Traffic Signal Controller Replacement. The largest project is Park Building Rehabilitation for $368,650. Information on each of the projects is available in the *Volume II, Projects Budget*.

A complete discussion of the total Infrastructure Renovation and Replacement Program and its current status is contained earlier in this Transmittal Letter in the *Major Project Efforts* section. One of our major tasks during FY 2004/2005 will be to complete and validate the entire inventory of infrastructure components within the City and to update cost estimates for infrastructure projects.

## INTERNAL SERVICE FUNDS

The City utilizes internal service funds to account for the financing of goods and services provided by one department or agency to other departments or agencies of the City. There are two such funds that operate on a cost reimbursement basis: the General Services Fund and the Employee Benefits and Insurance Fund. Both of these funds play an important role in the overall ability of the City to conduct business. Sunnyvale's full cost accounting methodology results in all of the costs of these funds being charged back to user activities on a rental rate or additive rate basis. Therefore, the total expenditures of these two funds are not added to the overall budget.

Beginning in FY 2002/2003, the City created two additional internal service funds. One of the new funds accounts for activities associated with the Sunnyvale Office Center, an office complex located at 505 W. Olive purchased in FY 2001/2002 to provide potential expansion opportunities for the Civic Center complex. The other new fund was created to separate property and liability insurance costs from the Employee Benefits and Insurance Fund.

## General Services Fund

The General Services Fund provides a wide range of important support services to programs within the City. These services range from fleet, to building maintenance, to technology and communication services. Funding for these services is recovered through rental rates charged to benefiting program operating budgets. The rental rates may include not only the cost of operations, but also the cost of replacement for depreciable equipment. This assures the availability of funds to replace equipment at the most cost-effective time.

Aggregate rental rate increases for General Services Fund activities are projected at 1.9% for FY 2004/2005 and an average of 2.8% over the remaining years of the financial plan. Rental rates are lower in the second ten years of the plan. Overall, rental rates are lower than those projected last year.

As part of the fiscal strategies to be employed in FY 2004/2005, staff is planning to re-examine the assumptions, models, and schedules used in preparing the City's various rental rates. Furthermore, staff will be reviewing the use of reserves and their impact during next year's rental rate development process.

There are a number of sub-funds within the General Services Fund in order to recognize distinct support service functions and establish appropriate rental rates for each. Included in each section is a brief description of major items that effect the current resources, current requirements, or reserves of each plan.

### *Fleet Services Sub-fund*

The Fleet Services program reflects the cost of ownership of City vehicles and equipment. A primary objective of Fleet Services is to provide rental rates that are competitive with those offered in the private sector.

The main source of funding within this Sub-fund is derived from Fleet Services rentals to other programs. However, other items that affect the current resources of this fund are also discussed below.

The Fleet Services rental is scheduled to increase by 4.5% for FY 2004/2005 or $137,447 above the current fiscal year. This increase is due to the fact that the planned 15% reduction in the City's Fleet Inventory was not achieved. Based upon the submissions of City programs to the City's Fleet Manager a total value reduction of 12.6% was achieved through implementing the service level reductions approved in the Adopted FY 2003/2004 Budget. An average annual increase of approximately 2.7% is projected for the remainder of the plan.

The Sale of Property line item of the Financial Plan represents the sale of surplus or replaced vehicles or pieces of equipment. The large figure in the current year represents the sale of the Library's Bookmobile. For the remainder of the plan an historical average of the sale of assets is used.

The Intrafund Loan Repayment represents scheduled payments from the Facilities Management Services Sub-fund. This loan was initially made in FY 1999/2000 to alleviate cash flow issues experienced by the Building Services Sub-fund. The initial terms of the loan were for a principal amount of $1.6 million to be repaid over 10 years with final payment scheduled for FY 2015/2016. Since its inception the loan repayment schedule has been accelerated to a new term of 7 years.

The multiple transfer line items found within the Current Resources section of the financial plan represent the funding mechanisms for a Capital Project Upgrading the City's Fuel Stations.

The two major current requirements deal with equipment replacement and operation of the Fleet Services Program.

As mentioned in the previous section, the large expenditures under the Capital Projects line item of the Financial Plan represent budgeted costs associated with the upgrade of the City's fuel stations.

The Equipment Replacement Reserve represents the accumulation of annual rental rates received from City programs, net of replacements purchased during the current fiscal year, for future replacement of vehicles and equipment. This reserve correlates with the equipment replacement line item under the *Current Requirements* section of the sub-fund. For example, when a large value item is scheduled to be replaced such as a street sweeper or a fire engine, the equipment replacement reserve will be drawn down as the accumulated annual replacements fund within the reserve will be used to purchase the vehicle or apparatus.

The *20-Year RAP Reserve* functions in this fund, as in other funds, to levelize rates and plan for capital projects.

***Facilities Management Services Sub-fund***

The Facilities Management program reflects the cost of maintaining City facilities (including costs for electricity and water), free standing furniture, modular furniture, and building equipment.

The Facilities Management Services Sub-fund has two rental rate revenue items, one relating to space rental and the other relating to equipment. The space or Facilities rental is based upon the total square footage of building space throughout the City. This square footage is then divided amongst the various City programs. The equipment rental accounts for replacement costs associated with modular and freestanding furniture, carpet, and blinds, and building maintenance equipment. For FY 2004/2005 the aggregate rental rate is scheduled to decrease by approximately 5% or $136,369 as compared to the current year. This decrease is due to service level reductions planned for FY 2004/2005 as part of the implementation of the service level reductions approved in the Adopted FY 2003/2004 Budget. An average annual increase of approximately 2.7% is projected for the remainder of the plan.

The major current requirements deal with equipment replacement and operation of the Facilities Management Services Program. The increase in planned operating costs for FY 2004/2005 is directly attributable to increase in costs associated with the provision of utilities for City facilities.

The Lease Payments line item in the financial plan represents a transfer of rental rate revenues received from City programs currently housed at the 505 W. Olive Sunnyvale Office Center. These funds are collected in this sub-fund and then transferred to the Sunnyvale Office Center Sub-fund to partially fund the facility management costs associated with that facility.

The Interfund Loan line item in the financial plan represents loan payments to the Fleet Services Sub-fund. As was mentioned in the *Fleet Services* section this loan was made to alleviate cash flow constraints of the Facilities Management Sub-fund in FY 1999/2000. The original terms of the loan called for repayment over a 10-year period; however, staff has since accelerated the payment schedule to a term of 7 years.

The equipment replacement reserve represents the accumulation of annual rental rates received from City programs, net of replacements purchased during the current fiscal year, for future replacement of office furniture, carpets and blinds, and building maintenance equipment.

The *20-Year RAP Reserve* functions in this fund, as in the other funds, to levelize rates and provide for planned capital projects.

### *Technology/Application Services Sub-fund*

Beginning in FY 2004/2005 this sub-fund will combine the two previous sub-funds associated with the City's Information Technology Department. These two sub-funds were combined for ease of administration as the department has completed an operating restructure to the outcome management budgeting system. As a result of the restructure both Technology and Communications equipment related charges and their associated operating costs will be budgeted in one program. Twelve factors contribute to the total user charge: network infrastructure, central computer maintenance, desktop maintenance, training, development of equipment specifications and/or applications, administrative and support services, technology equipment replacement costs, communication equipment, office equipment, mail services, print shop services, and telecommunication franchise (all KSUN related equipment). All software application related services have been incorporated into a separate program. Three factors contribute to the total user charge for application support: software maintenance, project management, and administration and support services.

As mentioned above this new sub-fund represents the combination of the previous Technology Services Sub-fund (595-300) and Communications Services Sub-fund (595-400). The rental revenue line items are listed separately for ease of comparison to previous year's financial plans. For FY 2004/2005 the aggregate rental rate is scheduled to increase by approximately 4% or $283,398 as compared to the current fiscal year. An average annual increase of approximately 3% is projected for the remainder of the plan

The Miscellaneous Revenue line item in the financial plan accounts for royalty revenue received from the City's SUNGIS software application.

The transfer from the Asset Forfeiture Fund and $451,583 of the transfer from the General Fund represent the funding components of a capital project for updating the City's computer network and information security infrastructure. The remaining transfer from the General Fund represents funding for costs associated with maintenance of the City's cable franchise agreement.

The two transfers from the Employee Benefits Fund represent funding donated by City employees to extend the timeframe of employment for those employees whose positions were eliminated as a result of the implementation of the service level reductions approved in the Adopted FY 2003/2004 Budget.

The major current requirements of this sub-fund deal with equipment replacement and operation of the Technology Services Programs.

The $531,583 in the Capital Projects line item of the financial plan for FY 2003/2004 represents costs associated with the updating of the City's computer network and information security infrastructure. The resources under the Project Operating line item represent the ongoing costs that will be assimilated into the Technology Services Program upon completion of the program.

The General Fund Loan repayment line item of the financial plan represents the repayment schedule of a $2 million loan made to the former Technology Services Sub-fund (595-300) in FY 1999/2000. This loan was made to help alleviate cash flow issues experienced by the sub-fund at that time. The original term of the loan was 10 years with payments scheduled to begin in FY 2009/2010. Staff has accelerated the payment of this loan such that initial payment is scheduled to begin in FY 2006/2007.

The equipment replacement reserve represents the accumulation of annual rental rates received from City programs, net of replacements purchased during the current fiscal year, for future replacement and maintenance of network infrastructure, central computer maintenance, desktop maintenance, training, development of equipment specifications and/or applications, administrative and support services, technology equipment replacement costs, communication equipment, office equipment, mail services, print shop services, and telecommunication franchise (all KSUN related equipment).

The *20-Year RAP Reserve* functions in this fund, as in other funds, to levelize rates and provide for planned capital improvements.

***Sewer Equipment Sub-fund***

The Sewer General Services program has responsibility for all equipment at the Water Pollution Control Plant and all equipment for the wastewater collection system. These rental rates are applied exclusively to the Wastewater Management Fund. For FY 2004/2005 the rental rate is scheduled to increase by approximately 1% or $6,839 more than the current fiscal year. An average annual increase of approximately 3% is projected for the remainder of the plan.

### *Public Safety Equipment Sub-fund*

The Public Safety Department has responsibility for the General Services program that manages all fire and police service equipment. All rental rates are applied exclusively to Public Safety Programs within the General Fund. For FY 2004/2005 the rental rate is scheduled to increase by approximately 23.8% or $55,233 as compared to the current fiscal year. The vast majority of this increase is due to the addition of fire turnout gear to the equipment rental rate schedule that was previously incorporated as part of the Department of Public Safety's operating budget. As a result of this transfer the Department of Public Safety's operating budget has been reduced by $44,500 thus mitigating the impact of the increase in rental rates. An average annual increase of approximately 3% is projected for the remainder of the plan

The General Fund Loan repayment line item of the financial plan represents the repayment schedule of a $450,000 loan made in FY 2000/2001. This loan was made to help alleviate cash flow issues experienced by the sub-fund at that time; specifically, these funds were used for replacement purchases of Self-Contained Breathing Apparatus (SCBA) units. The original term of the loan was 9 years of an annual payment of $20,000 starting in FY 2007/2008 through FY2011/2012 and $243,659 starting in FY 2012/2013 until FY 2015/2016. Staff has increased the dollar amount of the first portion of the loan repayment.

### *Parks and Recreation Equipment Sub-fund*

The Parks and Recreation Department has responsibility for the General Services program that manages all leisure services equipment. Examples of this equipment include pool covers, theater lighting, gymnastic equipment, and theater staging equipment. All rental rates are applied exclusively to the Community Recreation Fund. For FY 2004/2005 the rental rate is scheduled to increase by approximately 1.5% or $665 more than the current fiscal year. An average annual increase of approximately 2.8% is projected for the remainder of the plan.

As part of the fiscal strategies to be explored in FY 2004/2005 staff is planning to evaluate the feasibility of incorporating this rental rate structure into the Recreation programs' operating budget.

### *Project Management Sub-fund*

This sub-fund represents project management services provided by staff within the Department of Public Works Engineering Service Program. These services are associated with the various capital and special projects currently incorporated within the City's 10-Year Capital budget. The transfers into this fund represent the proportionate share of the current schedule of projects that the project management group is responsible for overseeing.

The current year operating figure is uncharacteristically low due to the large number of Measure B projects currently being administered by the Project Management program. Measure B grant regulations require that charges for services such as those provided by Project Management be charged directly to the Measure B funds rather than charged to this general services account and then applied as overhead to the projects. This requirement causes the costs included in Project Management to be understated. Since Measure B funds will be exhausted by the end of FY 2003/2004, this situation will not occur again.

As part of the fiscal strategies to be examined in FY 2004/2005, staff will be reviewing the question of what base level of project management is required by the future 10-Year Capital Budget.

## Employee Benefits and Insurance Fund

The Employee Benefits and Insurance Fund provides a mechanism to cover expenditures related to pension costs, employee insurance plans, workers' compensation costs and leave time while applying the principles of full cost accounting. This is accomplished by charging an additive rate to staff salaries wherever personnel hours are budgeted and expended. To better track and analyze expenditures, the Fund was separated into four sub-funds for FY 2002/2003: Leaves Benefit, Retirement Benefits, Workers' Compensation and Insurance and Other Benefits. Liability and property insurance, previously a part of the Employee Benefits and Insurance Fund, was broken out into its own fund because these costs are not related to salary expenditures, but instead recovered on claims experience and building space usage.

As identified and budgeted last year, employee benefits costs are significantly higher for FY 2004/2005 and are the major driver of higher operating costs. For FY 2004/2005 total expenditures in the combined fund are up by $8.5 million over the current budget, or a 21% increase. Although most of this increase was budgeted for last year, benefits costs, primarily in CalPERS retirement costs, continue to increase higher than budgeted. With labor costs the largest component of operating expenditures, these increases, especially when they are outpacing revenue trends, are problematic for the long term financial picture. Details of the benefits increases are discussed in the sub-fund sections below.

### *Leaves Benefit Sub-fund*

The Leaves Benefit program accounts for all City employees' leave time, including accrual of outstanding leave benefits. The additive rate is calculated by determining the amount of leave benefits to be accrued and adjusting for estimated salary increases. In addition, the reserve level is reviewed to ensure that all unused leave is appropriately reserved. For the long range financial plan, the reserve level is adjusted to account for increased retirements in the next three to five years. Over the next year, as part of the fiscal strategy, this reserve level will be analyzed in more detail to reflect changes and trends in the workforce over the twenty-year planning period.

***Retirement Benefits Sub-fund***

The Retirement Benefits Sub-fund contains the costs for the City's retirement plan. Sunnyvale contributes to two California Public Employees Retirement System ("CalPERS") plans for and on behalf of its employees: Safety (3% @ 50 Plan) and Miscellaneous (2% @ 55 Plan). The City pays the employee contribution as well as the employer contribution for these plans. While the employee contribution rate is set by law, the employer contribution rate is adjusted by CalPERS through an actuarial analysis and is impacted by its investment portfolio. The contribution rates are applied against employee salaries (PERSable earnings) in order to calculate the dollar amounts the City must contribute. Employer rates provided by CalPERS for FY 2004/2005 and projected by CalPERS for FY 2005/2006 are in the following table. Current year rates are also shown for reference.

| CalPERS Plan Employer Rate | FY 2003/2004 (actual) | FY 2004/2005 (actual) | FY 2005/2006 (projected) |
|---|---|---|---|
| Safety (3% @ 50) | 16.9% | 29.6% | 33.0% |
| Miscellaneous (2% @ 55) | 0.6% | 6.6% | 8.1% |

As the table indicates, the employer contribution rates are increasing significantly. It is important to note that these rates are set by CalPERS using actuarial analysis that is two years old. Therefore, the FY 2004/2005 rates include investment losses through FY 2001/2002 only.

Because of the City's long term financial planning, staff worked with our consulting actuary last year to incorporate the projected FY 2004/2005 rates into the twenty year financial plan. Additionally, we reviewed the CalPERS actuarial analysis and adjusted it for increases in salaries. As a result, the most significant increases have been budgeted for. However, at the time the long range plan was developed last year, the investment results for FY 2002/2003 were not known, so the FY 2004/2005 rates were reflected for the remaining years of the planning period. Unfortunately, the investment losses continued for an historic third year, and the projected rates for FY 2005/2006 are higher than FY 2004/2005. These higher rates are now budgeted into the recommended budget.

As mentioned earlier, CalPERS experienced significant investment losses over the last three years. Long term contribution rates are based upon the assumption that investment earnings will equal 8.25% annually. In FY 2000/2001 CalPERS experienced a real loss of 7.2%, and in FY 2001/2002 a real loss of 6.1%. Results for FY 2002/2003 were an investment gain of 3.7%, 4.5% less than the actuarial assumption. These investment losses have had a dramatic impact on the assets in our employer account at CalPERS and therefore our contribution rates. Fortunately, FY 2003/2004 has seen a turnaround in the CalPERS portfolio. Returns as of February 29, 2004 were 15.9%, although the market has seen a drop in the interim. Nevertheless, market returns higher than the actuarial assumption will help to stabilize rates and prevent further increases.

The effect of marked increases in CalPERS rates has been particularly noticeable in Public Safety additive rates. The change in the Public Safety plan from 2% @ 50 to 3% @ 50 in FY 2000/2001 represented a 50% increase in the value of the retirement benefits for Public Safety members. This enhancement was made possible in large measure by the large surplus assets in the Public Safety plan, and an agreement between the City and the Public Safety Officers Association was made to split the estimated additional cost of the retirement enhancement equally between the City and the Association. The current and projected extraordinary losses in CalPERS assets have resulted in significant increases in public safety retirement costs and in the cost of the 3% @ 50 benefit. By FY 2004/2005 the additive rate for sworn personnel will be almost 100% of direct wages because of the higher CalPERS rates.

The continuing increase in retirement costs has a significant impact on expenditures, particularly when reflected over the long term financial planning period. As part of the fiscal strategies, staff will be analyzing the actuarial data to determine how to budget these costs over the long term and where and how to moderate these costs.

***Workers' Compensation Sub-fund***

The Worker's Compensation Sub-fund is funded through the use of an additive rate that is applied to all staff salaries. This additive rate is based upon actual usage of the City's Workers Compensation program. For this reason, the City charges a variable additive rate depending upon the classification of the employee. In other words, more high risk positions, such as a Public Safety Officer, are charged a higher rate than an administrative employee.

The City currently is self-insured for workers' compensation costs but maintains excess insurance above what is known as the self-insured retention ("SRI"). The SRI level functions similar to deductible on a standard automobile insurance policy. The City pays for any claim losses incurred below the SRI level and the insurance carrier or risk pool pays losses over the SRI amount. Currently the City is in the final year of a very favorable insurance contract, with the SRI level set at $275,000. Staff is currently in the process of obtaining a replacement excess insurance policy, and has found that the cost of continuing this coverage at the $275,000 SRI would have increased by more than 4 fold, from $175,000 to about $750,000. Staff has reviewed the City's historical workers compensation claims and found only 7 instances in the past 15 years where the City's SRI threshold was exceeded. As a result of this analysis staff is recommending that we purchase excess insurance with the SRI at $500,000. By increasing the SRI threshold the City will realize premium savings of approximately $350,000 over what would have been required. The recommended FY 2004/2005 Budget includes the workers' compensation excess insurance premium at $365,000.

Staff in conjunction with the City's benefits actuary has revised the reserves of the Worker's Compensation Sub-fund. This new reserve model assumes a starting reserve requirement based upon an actuarial analysis of approximately $11 million. Added to the initial reserve requirement are the estimated number of new claims and associated costs. The ending reserve requirement assumes the total obligation of the initial reserve in addition to the anticipated number of claims net of estimated payments for the fiscal year.

As the area of Workers Compensation reform continues to be debated, staff will monitor future State legislation and its potential impacts on the City. As part of the fiscal strategies staff is researching new program measures for high risk programs that will assist in monitoring and containing the number and severity of claims.

***Insurance and Other Benefits Sub-fund***

The Insurance and Other Benefits Program includes costs for all the employee insurance plans including medical, dental, vision and life insurance. This program also includes the costs of the City's incentives programs such as the Management Achievement Program, Disability Incentive Program and Service Awards. Expenditures also include the costs for administering these programs.

The largest cost in this Program is medical insurance for our employees. Based on the most current information, the increase in medical insurance costs are budgeted at the same level as reflected in the current budget, 15% for FY 2004/2005 and 12% for FY 2005/2006 and FY 2006/2007. Increases in the high single digits are maintained through the remaining planning period. It is important to note that the budget assumes the current employee share of these plans is maintained such that SEA and PSOA employees will take on a larger share of these increases.

In this recommended budget, the medical insurance costs are broken out by active employees and retirees to reflect the significantly increasing costs for retirees. Although there are currently enough reserves to pay for the City's share of retiree medical costs, current additive rates cannot fully fund these costs over the long term. As a result, increased additive revenue in the amount of $2.2 million, growing annually with inflation, is reflected in the last ten years of the financial plan. Without this additional revenue, medical costs are severely underfunded over the planning period. As part of the fiscal strategies, staff will be analyzing ways to contain medical costs for both active employees and retirees in the next year.

**<u>Liability and Property Insurance Fund</u>**

This fund was established in FY 2002/2003 to separate out liability and property insurance costs from the Employee Benefits and Insurance Fund. Separating these costs into a separate fund provides better accountability of expenditures and allows the City to recover costs based on usage rather than on salary expenditures.

The Liability Property Insurance Fund is funded through transfers from its dependent funds rather than on an additive rate basis. This insurance coverage is applied to the maintenance of the City's infrastructure and covers the City against claims such as a Trip and Fall, Vehicle Damage, and damage caused by City trees.

Currently, the City participates in a risk pool administered by the California Joint Powers Risk Management Authority.

As part of the future fiscal strategies staff plans to review the City's use of its current risk pool and will perform a comparative analysis of alternative insurance strategies. Furthermore, staff will be implementing new service measures that will assist in the containment of future costs.

**Reserve Levels in Employee Benefits and Insurance Fund**

Reserves in the Employee Benefits and Insurance Fund have been set at amounts recently established by actuarial studies or staff analysis, as discussed above. The reserve levels as of June 30, 2004 are expected to be as follows:

| Reserve Item | FY 2003/2004 Year-End Amount |
|---|---|
| Workers' Compensation | $ 11,591,714 |
| Vacation Leave | 7,393,429 |
| Insurance and Other Benefits | 10,675,141 |
| Liability and Property* | 1,663,070 |
| **Total Employee Benefits Fund Reserves** | **$ 31,323,354** |

*Liability and Property were separated into a new fund for FY 2002/2003.

**Sunnyvale Office Center Fund**

A new fund was established in the FY 2002/2003 Budget to account for the activities of the Sunnyvale Office Center located at 505 W. Olive Avenue, across from the main City Hall. The Sunnyvale Office Center was purchased in April 2001 by the issuance of variable rate Certificates of Participation ("COPs") to provide expansion opportunities for the Civic Center Complex. Activities included in this fund are maintenance and operations of the office facility, capital projects, and debt service. Revenues to this fund consist of rental from outside tenants and City operations, and interest on reserves.

In FY 2002/2003, the remainder of the proceeds of the COPs was transferred in from the Capital Projects Fund, where they had originally been deposited. For FY 2003/2004 the interest earnings attributable to this fund that had previously been earned were transferred in from the Capital Projects Fund.

When the fund was established, it was projected that the existing office buildings would be operated and leased through FY 2005/2006, when a long-term solution to the City's office space problem could be in place. Subsequently, plans for a new civic center complex have been put on hold because of the City's financial situation. The FY 2004/2005 Long-Term Financial Plan therefore shows the complex being operated for the entire 20 year planning period. Increasing the length of operation causes the office complex to generate more net income than originally anticipated; this allows the

Sunnyvale Office Center Fund to give a rebate to the General Fund of about $200,000 annually over the entire planning period.

Because of the age and general condition of the office buildings, it was necessary to propose capital improvements in the amount of $654,000 in the first ten years in order to keep the facility in working order for the additional years that it would be in operation. The capital improvements would begin in FY 2004/2005 and continue through FY 2006/2007. A similar set of capital improvements is proposed in the second ten years of the plan in order to maintain the facility as an earning resource.

Staff has also modified the interest rate assumptions to account for the likely increase in interest rates in the near future. Currently, the COPs weekly interest rate is less than 1%. However, given recent indications from the Federal Reserve's Federal Open Market Committee staff has increased the assumed interest rate to 3% beginning in FY 2005/2006. This interest rate represents the approximate historical average of the Bond Market Association's Municipal Swap Index.

## FIDUCIARY FUNDS

### Dorolou P. Swirsky Youth Opportunity Fund

In August of 1993, City Council accepted Dorolou Swirsky's gift of her trust estate to establish an ongoing Youth Opportunity Fund to specifically address sports, recreational, social, cultural, and educational activities for disadvantaged youth living in Sunnyvale.

The Dorolou Swirsky estate was donated to the City upon her death in March of 2000. The estate consisted of a single family home located at 1133 Hollenbeck Road. At the time of donation an appraisal was performed on the property, and the total value was estimated at $555,000. Following the donation, the City established the Swirsky Youth Opportunity Fund to account for the proceeds. Ms. Swirsky had taken a reverse mortgage on the property which the City paid using General Fund monies. The property was rented out for $2,650 per month until August of this year. Net proceeds realized each year of the lease agreement were approximately $20-25,000, and were used to help pay back the General Fund for the reverse mortgage.

In November of 2003, Council approved a resolution authorizing the sale of 1133 Hollenbeck Road. The proceeds of the sale were used to pay off the obligation to the General Fund and the remainder was placed into the Swirsky Youth Opportunity Fund to form a nonexpendable trust fund. In accordance with Council's action, one-third of the interest generated each year by the principal are to be used to provide summer recreational equipment and supplies to disadvantaged youth through an agreement with Sunnyvale Community Services. The remaining two-thirds of the interest generated annually by this fund will provide grants for agencies supporting disadvantaged youth to be administered through the joint Arts Commission and Parks and Recreation Commission. Those interested in more detail are referred to Report to Council 03-392.

**Fremont Pool Endowment (Trust) Fund**

The Fremont Pool Trust Fund was established by the City in FY 2002/2003 to account for the receipt of monies raised by The Friends of Fremont Pool, a group of residents who lobbied City Council regarding the need for a new pool in Sunnyvale. The Fund currently has an Endowment Reserve balance of $810,049. The basic premise of this fund is that the corpus, or principal, is never expended. Rather it is invested in a safe, interest-generating market. Each year the interest generated by this fund is used to help offset the City's cost of operating the new, 50-meter pool constructed in partnership with the Fremont Union High School District at Fremont Union High School. The City's cost is determined by adding 50% of the cost of maintaining the pool itself (performed by the School District, which subsequently bills the City); and 100% of the City's cost of maintaining the public shower/locker facility; and staff costs related to oversight of the contract with California Sports Center, a private firm which the City has engaged to program and operate the City's share of the Fremont Pool, then subtracting the revenue received by the City from CSC. Any surplus amount of interest is returned to the fund for possible use in future years. During its first year of the new pool's operation, this fund was able to generate sufficient interest to pay the entire net cost to the City. Staff and the District note that this was not a normal year in terms of expenses, and that future years are likely to cost more. It should also be noted that while the corpus of this fund may grow a bit in future years (assuming continued contributions), it is not expected to increase markedly over time. As a result, it is not expected to keep up with inflation and the purchasing power of the interest it generates will likely erode over time. If in future years this fund generates insufficient interest to pay the City's net expenses, the General Fund will need to make up the difference. In this context, and the City's current budget crisis, it is critical to note the importance of allowing the California Sports Center to charge market rates for use of the pool. The net revenue received by the City from CSC, and the interest generated by the Fremont Pool Trust Fund, are critical factors in allowing the pool to support itself financially.

## CONCLUSION

As your City Manager, I am honored to have the opportunity to present to you my recommendations for the FY 2004/2005 Budget, the Ten-Year Resource Allocation Plan, and 20-year financial forecast. <u>Even in this period of economic difficulties, each fund is balanced to the twentieth year assuming successful implementation of the fiscal strategies and action items identified in this Transmittal Letter.</u> The goal this year is to achieve long term financial stability and eliminate a structural imbalance between revenues and expenditures that exists over the first eight years of the Long Term Financial Plan.

Two final points need to be made. First, Sunnyvale's planning and financial management systems are providing the foundation on which we are building the solutions to the City's budget crisis. Without this foundation, we would have found ourselves unprepared to respond to a budget crisis of this magnitude. This budget crisis requires that the City "change its lifestyle" to adjust to our new fiscal realities. Our planning and management systems provided the framework and the information in order for staff to make recommendations and for Council to make the final decisions.

Second, although we have recommended ways to close the General Fund structural gap, our job is not over. Staff has identified a number of fiscal strategies that will be explored during FY 2004/2005 to bring our ongoing revenues and expenditures into alignment over the long term. Staff will continue to pay close attention to local economic conditions, our revenue patterns and expenditure trends, and State legislative actions. Any changes to our strategies for addressing this budget crisis will be presented to the City Council for policy direction and final action.

The City's approach to budgeting and long-term financial planning is complex, and highly valued in this organization and in our community. In preparing the recommended FY 2004/2005 Budget and Ten-Year Resource Allocation Plan, I am fortunate to have had the support and assistance of exceptional staff who continually go beyond the call of duty.

First, I would like to say a heartfelt thank you to Deputy City Manager Chuck Schwabe for his efforts in coordinating the Council's new budget service review process this year. Also, given the new process, much staff work was undertaken by department directors and program managers in a very short turn around time. I am grateful to them for their support and commitment to provide timely and complete information to the Council for consideration.

Of course, the budget would not have been prepared without the talented and dedicated budget team led by Mary Bradley, Director of Finance and Grace Kim, Finance Manager. These team members, including Mark Eyrich, Kurtis Mock, Charlene Sun and Tim Kirby, did a yeoman's job in putting the budget together and I greatly appreciate their dedication.

Finally, I would like to thank Council for their leadership and support and their

commitment of time in developing the new budget process, community outreach, and policy direction.

Respectfully Submitted,

________________________

Amy Chan
City Manager

May 18, 2004

## APPENDIX A
## STRATEGIES AND COST SAVING IDEAS TO BE EXPLORED IN 2004/2005

| |
|---|
| **EMPHASIZE ECONOMIC DEVELOPMENT** |
| Reexamine economic development strategies to ensure that short term and long term goals are achievable and deliverable |
| **USE TECHNOLOGY TO REDUCE COSTS** |
| E-mail business newsletter rather than mail hard copy |
| Substitute e-mail for paycheck stuffers |
| Continue roll out of hand held units for field operations in Public Safety |
| Use citywide smart card connected to utility billing as way to collect all Library fees, fines, registration |
| Enhance/add Library self-check machines to keep up with increased use and allow payment of fines |
| Establish investment fund to review and implement automation of processes citywide that are not currently automated |
| Continue the deployment of remote meter reading technology |
| **EXPLORE ALTERNATIVE SERVICE DELIVERY METHODS** |
| Review organization of Emergency Preparedness program in DPS, determine use of sworn vs. non-sworn positions |
| Explore contracting out recreation services where appropriate |
| Redesign Organizational Effectiveness program to focus on PAMS and cost containment practices |
| Expand outsourcing of printing services |
| **MANAGE/CONTAIN EMPLOYEE SALARIES AND BENEFITS** |
| Utilize flexible schedules to reduce overtime needs |
| Eliminate city cars except for field inspections |
| Investigate tiered employee benefits for new hires |
| Accumulate PTO at earned salary rates rather than current rates |
| Lower the cap on employee vacation/PTO accumulation; allow payoff yearly |
| Eliminate tuition reimbursement for staff |
| Conduct audit of overtime usage citywide |
| Explore alternate medical insurance plans |
| Revisit uniform use and rental citywide |
| Institute a vesting requirement for retiree medical benefits |
| Investigate substituting a PTO program for disability where possible |
| Review benefit levels for prescription safety glasses, safety shoes, and wildland boots |
| Revisit definition of family emergency leave |
| Revisit benefit level for staff medical examinations |
| Review payment of certifications for various position in City |
| Review provisions of new workers' compensation law |

| |
|---|
| Review workers' compensation legal requirements as they relate to selection of physician and time off for workers' compensation medical appointments |
| Reevaluate the disability leave incentive program |
| Focus on reducing workers' compensation claims/costs |
| **STREAMLINE CITY PROCESSES** |
| Hold Library Board meetings 6 times a year |
| Develop processes with more input at the beginning so that each step is consistent with the others |
| Combine Parks and Recreation Commission with Arts Commission |
| Consolidate/update administrative policies |
| **MANAGE THE CITY'S "LIFESTYLE" AND EMPLOYEE EXPECTATIONS** |
| Review level of items supplied by central stores to employees |
| Reuse paycheck envelopes by not sealing them |
| Reduce low use fire apparatus |
| Pull cell phones from Police patrol cars |
| Relocate/consolidate offices to make more efficient/effective use of space |
| Cut distribution of news clips |
| **EXPLORE REDUCING CITY HOURS OF OPERATION** |
| Close City offices between Christmas and New Years with use of PTO or unpaid time |
| Utilize different/shorter business hours for the public |
| Reduce hours of one-stop center availability |
| Close Library for 2 one-week periods a year (December and August). This equals about a 5% decrease for all staff costs. Savings would be realized by gradual (3 year) salary reduction |
| **EXAMINE WAYS TO MORE EFFECTIVELY USE CITY WORKFORCE** |
| Eliminate one recreation support person, replace with lower position |
| Explore expanded use of job sharing and allowing more part time employees |
| Review management positions citywide for consistent span of control, supervisory levels |
| Evaluate internal training programs to ensure that all employees receive appropriate skills necessary to effectively perform their jobs |
| Eliminate/consolidate answer points in joint locations |
| Freeze vacant management positions in DPS during vacancy of Chief |
| Change traditional backfill requirements in Fire when a short term (sick day, etc.) vacancy occurs |
| Share DPS maintenance person with another department |
| Study Pay for Performance System |
| Review Public Safety training costs; develop inventory of mandatory Public Safety training; review training hour provision of PSOA side letter |
| Review practice of fire station staffing versus requirements in MOU |
| Review patrol minimum staffing requirements in MOU |
| Investigate use of part time Public Safety Officers and Public Safety retirees |
| Review start times for Patrol schedule |
| Evaluate need for Sworn/non-sworn management positions in DPS |

| |
|---|
| Share DPS Financial/Management position with another department, e.g. Finance |
| **REVIEW FUND RESERVE POLICIES** |
| Review reserve policies for all funds for level and appropriateness |
| Review all equipment replacement reserves |
| **REVIEW CITY'S COST RECOVERY POLICY FOR FEES AND CHARGES** |
| Charge homeowners for a portion of concrete replacement costs |
| Charge fees for concrete replacement on commercial properties |
| Explore full cost recovery of DPS permits for taxicabs, adult entertainment, pawn shops, massage parlors, and weapons |
| Revisit policy of keeping utility rates below average of surrounding cities |
| Update subsidy analysis of Community development, Recreation, and SCI3 programs |
| Develop full cost recovery of art in private development program |
| **INVESTIGATE NEW AND INCREASED REVENUE SOURCES** |
| Expand park picnic rental services, e.g. inflatable jumpers, etc. |
| Explore entertainment tax |
| Explore increase in Business License Tax |
| Explore increase in Transient Occupancy Tax |
| **EVALUATE CITY'S POLICY REGARDING LAND HOLDINGS** |
| Determine legal standing of Charles Street lot and responsibility for maintenance |
| Analyze additional income potential of 505 W. Olive property |
| **MISCELLANEOUS** |
| Update Phase I of the Long Range Infrastructure Plan and complete Phase II |
| Evaluate recreation services fee waiver program and program administration |
| Complete optimal staffing study for Public Safety Department |
| Evaluate use of CDBG funds for senior services support |
| Evaluate use of various City housing funds |
| Undertake comprehensive review and analysis of the outcome managementsystem |
| Develop and conduct PAMS training at all levels |
| Perform complete update and review of Capital Improvement Program, including unfunded projects over 10-year plan |